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MEGAFIRMS

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This Article documents and explains the amazing growth of the largest firms in law, accounting, and investment banking. Scholars to date have used various supply-side theories to explain this growth, and have generally examined only one industry at a time. This Article emphasizes a demand-side explanation of firm growth and shows how the explanation is similar for firms in all “project” industries. Legal regulation also plays an important role in determining industry structure. Among the areas covered in this Article are the growth of Multidisciplinary Practice firms (MDPs). MDP growth can best be understood by looking more broadly at the demand forces driving project industries. This Article also applies its framework to the breakup of the Big Five accounting firms, to the consolidation trend in the investment banking industry, and to the divergent growth patterns of the law firms in the plaintiffs’ securities litigation field.

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INTRODUCTION

Big, bigger, biggest. Corporate law firms have exploded in size in the last two decades. So have accounting firms and investment banks. Many are now mammoth entities with thousands of employees, billions in revenues, and offices throughout the world. In the past, a team of firms, through more or less formal syndication, was likely to share an especially large project. Today a single behemoth often handles the task by itself.

Why have megafirms developed in these industries (which we will call “project” industries because of their particular characteristics)? Most scholars emphasize one or another “supply-side” story.¹ Firm size increases as firms leverage the power of key partners, or create a name brand of high quality, or run internal tournaments to motivate recruits. The limits on growth arise largely from internal organization costs, as it becomes increasingly unwieldy to govern ever-larger firms.

The supply-side is only half the story, however. Client demand for larger projects has stimulated firms to grow, too. In this Article, we show that these megafirms arise at least partially in response to the increased client demand for bigger projects. In order to make our argument, we develop a demand-side model of firm structure for these industries.²

Our theory is based on an economic model of industrial structure

1. See generally Ronald J. Gilson & Robert H. Mnookin, *Sharing Among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits*, 37 STAN. L. REV. 313 (1985) (exploring “portfolio theory” as a basic supply-side explanation of why lawyers band together in firms); David B. Wilkins & Mitu Gulati, *Reconceiving the Tournament of Lawyers: Tracking, Seeding, and Information Control in the Internal Labor Markets of Elite Law Firms*, 84 VA. L. REV. 1581 (1998) (employing the “tournament theory” as a supply-side explanation of the growth of law firms).

2. Despite earlier calls to develop demand-side explanations of firm growth, see, e.g., Richard H. Sander & E. Douglass Williams, *A Little Theorizing About the Big Law Firm: Galanter, Palay, and the Economics of Growth*, 17 LAW & SOC. INQUIRY 391 (1992), we believe we are the first legal scholars to offer any demand-based theory.

and syndication in project-oriented service industries.³ Project industries include investment banking, law, accounting (both auditing and business consulting), construction, advertising, and filmmaking, among others, although this Article concentrates on the first three. Unlike the standard manufacturing industry of industrial-organization theory, the key fact of a project industry is that demand is lumpy, or equivalently, that the products are heterogeneous. Projects vary enormously in both their size and in the mix of inputs needed to complete them. For example, law firm projects might range from defending a sexual harassment suit involving a single employee to ensuring world-wide compliance of a company's sexual harassment policies with the laws of numerous countries.

In project industries, firms must choose their market niche. Gearing up to handle the largest jobs makes one less efficient at handling smaller jobs. As a result, firms in project industries vary dramatically in size, input resource mix, legal form, and project capabilities.

Even the largest firms, however, may find it too costly to handle the largest projects themselves. Syndication is always an alternative. Indeed, it is often more efficient for a syndicate of firms to handle especially large projects. Syndication, whereby two or more firms combine resources to complete a job, is a common feature of project industries.

A key element of the project-industry model is the firm's choice between syndication and internal growth. A project can be handled by a single firm, assuming the firm is large enough to perform the necessary work, or by forming a syndicate of smaller firms. Part of this choice depends on the supply-side—balancing the costs of coordinating the members of the syndicate versus the costs of coordinating the members of a larger firm. If a securities firm wants to bid on an equity offering that is bigger than it can presently handle, it could gear up to handle the job itself by hiring more investment bankers, thereby incurring internal organization costs. Alternatively, it could choose to form a syndicate with other firms to handle the distribution of the stock, incurring syndication costs. Over time, firms will consider the relative costs of these two alternatives, in relation to revenues, in making decisions about their future size.

3. The formal economic model is developed in Robert G. Hansen, Stewart J. Schwab, & Randall S. Thomas, *Structure, Competition and Pricing in Project-Oriented Service Industries* (unpublished Working Paper, Amos Tuck School of Business) (on file with authors).

The demand side affects the decision to grow or syndicate. Will many large jobs exist, or only a few? A firm is more likely to choose to expand internally (rather than to syndicate) if it forecasts that clients will demand enough projects of sufficient size to warrant fees to cover its additional internal organization costs. For instance, if the nationally based *ABC* law firm predicts that its clients will prefer to buy all of their international work from one firm rather than dividing the work into smaller segments on a national basis, then the firm will have an incentive to expand globally to handle the work by itself, even if it has to hire attorneys in other countries to do so.

Finally, firms cannot make this size choice in isolation because they are affected by what other firms are doing. Syndication requires partners. If other firms grow, they are less likely to form syndicates. To continue the law firm example, the *ABC* law firm will want to know whether its competitors are going to expand. If its competitors are growing, this will have at least two effects on *ABC*: first, its competitors will be more likely to secure big jobs to the exclusion of *ABC*; and second, *ABC* will have fewer potential syndicate partners with which to compete for big jobs because the other firms will be large enough to handle them in-house. So, *ABC* should be expected to consider its competitors' decisions to grow internally, or merge with one another, in making its own decision about expansion.

This Article argues that the demand for large jobs has grown in the last twenty years, so that the balance between syndication and large individual firms has shifted. Demand has grown because of new information technologies and increasing globalization, which allow corporate clients to grow in size and scope.⁴ Additionally (although we advance this more tentatively), corporate clients increasingly want one-stop shopping for projects. In response, a few leading firms have chosen to grow, internally or through mergers, to exploit this shift in client demand for large projects. These firms have decided that it would be more profitable to take these bigger jobs in-house rather than to use traditional methods of syndicating the work amongst several firms.

Examples of this expansion are rife in the law, accounting, and investment banking. Thus, in the year 2000 alone, such law firm luminaries as Pillsbury Madison & Sutro; Winthrop, Stimson, Putnam

4. See, e.g., Michael Orey, *Two Law Firms Set to Announce Plan to Merge*, WALL ST. J., July 17, 2001, at B2 (noting that the globalization of business has caused law firms to merge and globalize to remain competitive).

& Roberts,⁵ Paul, Hastings, Janofsky & Walker;⁶ Squire, Sanders & Dempsey,⁷ and others⁸ have been involved in mergers, while other megafirms have aggressively grown internally. Mergers have the advantage of bringing new clients to the firm but the disadvantage of potentially creating both conflicts of interest and internal dissension as the two firms struggle to integrate themselves.

Legal rules are a critical determinant in the ebb and flow of megafirms. Some legal rules restrain internal growth and favor syndication. A clear example are the ethical and legal restrictions on the world-wide efforts of firms to combine law and accounting into Multidisciplinary Practices (MDPs). Recent legal requirements for auditing independence are also causing dramatic cutbacks in the accounting megafirms.⁹ Other rules, however, favor megafirms. Two newsworthy examples are the regulation of securities fraud cases under the 1995 Private Securities Litigation Reform Act (the

5. *Id.* (“Pillsbury, Madison & Sutro, [sic] based in San Francisco, and Winthrop, Stimson, Putnam & Roberts, based in New York, expect to announce today their intent to unite their practices. The merger would create a firm with 820 lawyers in 17 offices.”). Throughout this Article we face the thorny issue of the correct punctuation of firm names, particularly the absence or presence of commas, blanks, and ampersands. In general, law firms have been good at observing formal rules such as the serial comma, including GPO Style Manual Rule 8.58’s exception of omitting the comma before an ampersand. However, we observe an emerging trend of deleting commas, and a lesser but noticeable trend of deleting the ampersand. Davis Polk & Wardwell has for years omitted the comma (although it keeps the ampersand, unlike the British firm Titmuss Sainder Dechert). Labeling the firm “Davis Polk & Wardwell” sends a subtle but powerful signal that someone is not “in the know” (analogous to not following bluebooking rules). Foreign firms seem less likely to use commas or ampersands, although no universal practice abroad exists either. For example, the London firm Slaughter and May rejects the ampersand in favor of the word “and.” Although unpacking this post-modern development arguably takes us beyond the scope of this Article, we theorize possible causes to lie in brandmarking of firms or in conforming to electronic grammar. Support for the brandmarking theory comes from the fact that accounting firms did this long ago, for example Price Waterhouse. But the future may link to e-commerce. Several financial and accounting firms have gone the no-space route, and even to internal capitalization. For example, the official websites name PaineWebber and PricewaterhouseCoopers. See *infra* note 113. We have tried our best to be accurate on firm names, generally by checking their websites, but make no guarantee in this fast-moving area.

6. *Id.* (“Last month, the 103-year-old New York firm Battle Fowler closed shop when 118 of its attorneys joined Paul, Hastings, Janofsky & Walker . . .”).

7. *Id.* (“Squire, Sanders & Dempsey, based in Cleveland, swallowed most of the attorneys in San Francisco-based Graham & James to produce a 675-lawyer firm.”).

8. Additionally, as recent as this year, the legal industry witnessed another megamerger of two large law firms: that of Chicago-based Sidley & Austin and New York-based Brown & Wood. *Law Firms Sidley Austin and Brown & Wood Merge*, WALL ST. J., Apr. 24, 2001, at A6. They combined to form Sidley, Austin, Brown & Wood, a Chicago-based firm with approximately 1,325 lawyers, and an annual revenue of about \$700 million. *Id.*

9. See *infra* notes 150–62 and accompanying text.

“Reform Act” or “PSLRA”)¹⁰ and judges’ use of auctions¹¹ of the lead counsel positions in some securities fraud cases. An unintended consequence of these reforms appears to be the creation of one megafirm that dominates plaintiffs’ litigation in the securities field.

The causal influence of legal rules goes both ways, however. Not only do legal rules influence the trade-offs between syndication and internal size, but firm organization puts pressure on legal rules as well. For instance, the Big Five accounting firms’ international clients are now asking those firms to handle both their accounting and legal matters.¹² In many European countries, these firms are permitted to do so, potentially resulting in substantial savings for their clients and benefits to the accounting firms. In the United States, however, lawyers and accountants have traditionally been prohibited from practicing together in a firm in which both are principals. American clients and the Big Five accounting firms have been pressing to change these rules, but substantial elements of the American bar have resisted this pressure, claiming that lawyers must maintain their independence from other service providers to ensure their advice to clients does not suffer from conflicts of interest. The Security and Exchange Commission’s (SEC) new regulations on auditor independence are based on a similar conflict-avoidance justification and will, if enforced vigorously, create a legal barrier to firms that seek to combine auditing and consulting services.¹³ Indeed, an interesting question is whether the American Bar Association (ABA) or the SEC is more likely to give way to economic pressures—that is, whether the ABA’s hostility to lawyer-accountant mixing is less vulnerable than the SEC’s hostility to auditing-consulting mixing. This depends on the degree of purported market failure in these two areas, and the degree to which regulatory intervention improves things.¹⁴

This Article proceeds as follows. In Part I, we develop our model of the factors that affect a firm’s choice between internal expansion and syndication. Part II examines how law firms have expanded rapidly both domestically and internationally over the past

10. Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified as amended in scattered sections of 15 U.S.C.).

11. For a discussion of judicial auctions as a regulatory mechanism for security fraud actions, see *infra* notes 295–98 and accompanying text.

12. Margaret A. Jacobs, *Accounting Firms Covet Forbidden Fruit: Piece of U.S. Legal Market*, WALL ST. J., May 31, 2000, at B1.

13. See *infra* notes 209–12 and accompanying text.

14. These are among the questions we explore in this Article. See *infra* notes 231–33 and accompanying text.

few decades. We predict continued increasing levels of merger activity between U.S. and foreign firms resulting from the race to develop global firms.

Part III examines the accounting industry, where the dominance of large firms is even more pronounced. We explain the growth of the Big Five as resulting largely from the demand by clients for large, multi-task projects. However, the recent emergence of consolidators, who are legally prohibited from auditing, demonstrates a new form of syndication between financial corporations and captive CPA partnerships. Additionally, the recent split of auditing and consulting services within Big Five accounting firms hearkens a return to a syndication model, at least for projects involving substantial elements of auditing. Finally, Part III also examines new developments in the multidisciplinary practice of accounting and law, in which firms are sometimes forced into a syndication relationship when they might prefer internal consolidation.

Part IV turns to investment banking firms and the public offering of securities. Syndication has historically played an especially prominent role in this industry, although the last few years have seen a decline in its importance. Our model, with its emphasis on client demand as a driving force behind the choice between syndication and internal growth, can explain the rise and fall of syndication in investment banking. We begin with a discussion of the traditional securities underwriting syndicate, and then examine the impact on underwriting syndicates of the globalization of securities markets and the SEC's promulgation of Rule 415,¹⁵ the shelf registration rule.

Part V applies our model to plaintiff-side law firms in securities fraud cases. Here, syndication between small firms is the norm, a result that judicial regulation heavily influences. The industry structure is changing, however, in response to the recent and still controversial practice of choosing lead counsel through judicial auctions, as well as in response to the passage of the 1995 PSLRA. Our model predicts how these developments will alter the number and size of law firms in this field. We then conclude with some general remarks about our analysis.

I. MARKETS, FIRMS, AND SYNDICATES

Economists and lawyers have tried for over fifty years to develop a robust theory of the firm. Beginning with Ronald Coase,¹⁶ law and

15. 17 C.F.R. § 230.415 (2001).

16. Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386, 390-94 (1937).

economics scholars have hypothesized, among other things, that firms are a nexus of contracts,¹⁷ or arise to minimize transaction costs,¹⁸ or act as a solution to team production problems.¹⁹ By contrast, virtually no attention has been paid to syndicates of firms.²⁰

Ronald Coase's schema created a dichotomy between the market and the firm. Markets are costly to use, taking time and effort to find trading partners, negotiate the price and other terms of the deal, and enforce the contract. Firms are created, as Coase sees it, to avoid these market transaction costs. Instead of many market contracts between various factors, a single contract (e.g., offer your labor at a certain salary to act according to the entrepreneur's instructions) occurs between the entrepreneur and other factors that comprise the firm. But firms have costs as well, particularly as they get larger. The entrepreneur encounters the organizational cost of directing many people and the related principal-agent problems that arise out of firm members' tendency to shirk responsibilities under the grand contract if not monitored closely.

Many scholars, particularly those insisting that the firm is a nexus of contracts, have attacked Coase for creating a false dichotomy between market and firm.²¹ In the firm and market, these scholars say, all is governed by contractual relations. Other scholars, indeed, have thrown up their hands and declared that determining what is a firm, and what is outside the firm, is a boring or irrelevant question.²² It is all a matter of shading of different types of contracts.²³

17. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976) (stating that firms "are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals").

18. See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* 385-408 (1985).

19. Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 794-95 (1972).

20. See Hansen, Schwab & Thomas, *supra* note 3 (discussing the limited research on the syndication of firms).

21. E.g., Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 COLUM. L. REV. 1757, 1761 (1989) (describing Coase's dichotomy between the authority of the firm and consensual trade in the market as a "conceptual weakness").

22. See Steven N.S. Cheung, *The Contractual Nature of the Firm*, 26 J.L. & ECON. 1, 3 (1983) (arguing that it is unimportant to distinguish between firm and market transactions); Benjamin Klein, *Contracting Costs and Residual Claims: The Separation of Ownership and Control*, 26 J.L. & ECON. 367, 373 (1983) ("Economists now recognize that such a sharp distinction [between intrafirm and interfirm transactions] does not exist and that it is useful to consider also transactions occurring within the firm as representing market (contractual) relationships. The question what is the essential characteristic of a firm now appears to be unimportant.").

23. See Victor P. Goldberg, *Regulation and Administered Contracts*, 7 BELL J. ECON.

Our model recognizes that there are many intermediate hybrids between firm and market. In particular, we emphasize the syndicate. A syndicate is created when admittedly distinct firms agree by contract, or less formally, to coordinate services on a particular project. Syndicates arise because, at any point in time, a firm may be too small, too busy at the moment, or otherwise lacks the resources to effectively handle the jobs that are available. The firm could expand to handle this work internally, but expansion is costly—particularly when the project seems of exceptional size, and when the firms' managers cannot predict with sufficient confidence whether there will be other large projects forthcoming. If the firm guesses wrong, the firm has incurred long-term internal organizational costs to complete a short-term project. An alternative to incurring long-term costs is to work with another firm on a temporary basis to complete a particular job. Syndicates are common in certain industries, such as the sale of securities for public companies, private venture capital financing for companies, or the representation of clients in complex transactions or litigation.

The distinctive feature of project-oriented service industries is that the product varies from transaction to transaction, and is both discrete and heterogeneous. For example, one of the major services provided by investment banks is the issuance and distribution of securities. This process involves significant amounts of advisory work, and the marketing and distribution of the instruments being sold. Each issuance is unique in the resources required, for example, to distribute the securities. Some issues will be large, others small. Some issues will be sold to institutional investors, while others will be primarily marketed to individuals. Thus, the resources needed for each issuance, such as the brokers and salespeople, will need to be tailored to the particular offering.

The heterogeneous product means that no single firm structure is optimal in supplying all products. The point sounds obvious, but it distinguishes these markets from traditional manufacturing industries. Consider the widget-manufacturing industry of traditional industrial-organization theory. If the least-cost method of manufacturing a widget is with a factory of five-hundred workers producing ten-thousand widgets a year, and aggregate demand is for one million widgets, one would expect a large number of factories each producing roughly ten-thousand widgets with five-hundred workers. Larger or

426, 426–27 (1976) (emphasizing similarities between long-term contracting between firms and coordination of activities within the firm).

smaller firms and firms with different mixes of capital and labor would, by assumption, be less competitive. In project industries, by contrast, not every project is alike. Projects that are large in scale and scope are made most efficiently by one type of “factory” (say, one that employs accountants and lawyers from several countries) while smaller projects are more efficiently made by other factories (say, one that employs only bankruptcy lawyers).

Importantly, shifts in demand affect project industries more profoundly than other industries. To continue our example, suppose the overall demand for widgets increases from one million to two million. We would not expect individual firms to grow, because this would make them less efficient. Rather, one would expect more firms (or more divisions of existing firms) to spring up, but the new enterprises would still employ five-hundred workers and produce ten-thousand widgets, to remain competitive with the existing enterprises. Contrast that with a shift in demand in a project industry, so that demand for large projects doubles but the demand for small projects remains constant. One would expect more large firms but not more small firms.

As relative demand for large projects increases, each firm in the project industry must decide whether and how to respond. One possibility is to increase its internal size or scope. Alternatively, it can join a syndicate of smaller firms, incurring syndicate costs rather than internal organization costs. The decision between internal growth and syndication depends on their relative costs as well as whether the shift in demand is seen as permanent or transitory. Internal growth is increasingly expensive in our model. A firm’s internal organization costs increased at an increasing rate in both scale (i.e., the overall size of the firm) and scope (i.e., the number of different inputs, such as tax lawyers, bankruptcy lawyers, and litigators). Diseconomies of scale arise because it becomes more difficult to manage the larger numbers of workers and other inputs needed for bigger projects. Diseconomies of scope occur because it is easier to manage an organization of homogeneous inputs. For example, an investment bank with only a small retail sales force is easier to manage than a bank with large retail and institutional sales forces. While improved information technologies may have expanded the efficient size of the firm by, for example, allowing more productive workers to use the same computer systems and thereby lower per unit costs, at some point the firm’s average cost curves start to slope upward as they grow bigger.

Importantly, these internal costs are relatively fixed regardless of

how many projects are completed in a particular time period. Even if the firm works on only a few projects, it must employ its inputs and bear organization costs. Thus, it is not worthwhile to be so large as to serve the largest projects, if they come too infrequently to justify the higher costs.

Syndication is another way for firms to complete bigger projects without incurring the high internal organization costs. The potential for savings through syndication seems clear: since firms must hire their inputs before knowing the actual nature of the jobs available in the next time period, it is likely that they will not be *ex-post* optimally structured. Syndication allows flexibility through *ex-post* re-configuration of firms' structures on a temporary basis.²⁴ Thus, law firms can syndicate work amongst several firms that offer different sets of services, either by area of specialization, or geography, or both.²⁵

Syndication has its own problems. Perhaps most obviously, revenues must be shared with other firms in the syndicate. The lesser revenues can be justified if the costs decrease, compared to internal growth. Syndicates are costly to run, however. Managing the workload between firms is not easy, particularly as projects become more complex. Agency costs arise as members attempt to free-ride off the work of other members, and occasionally take away the clients of another syndicate member.²⁶ This requires monitoring by the lead firm or the client. The monitoring costs may be very high when a syndicate has many members.

The equilibrium structure of a project-oriented industry at any one point in time can be viewed as a balancing of internal firm

24. Cf. Margaret A. Jacobs, *Law-Firm Mergers Take a New Turn as Plans for a 14-Way Union Are Set*, WALL ST. J., Oct. 27, 1999, at B23 (reporting that several small and midsize firms have responded to the growth of big firms by forming networks to refer business and share information, but not to share profits).

25. Syndication may also be necessary where national legal regimes prevent international law firms from expanding into local markets. For example, until recently, Japan and Singapore had legal rules that required foreign firms to form joint ventures with local law firms. SYDNEY M. CONE III, INTERNATIONAL TRADE IN LEGAL SERVICES: THE REGULATION OF LAWYERS AND FIRMS IN GLOBAL PRACTICE §§ 13.3, 16.3 (1996). Other countries have ethical rules that prevent local lawyers from working as employees of foreign firms. Still other countries restrict foreigners' practices to a representative office, advising only on foreign law. For further discussion of the treatment of foreign law firms by different countries, see *id.*

26. Clients may often be the ones that decide which firms will belong to the syndicate. Long standing relationships with certain firms may lead in-house counsel to select a particular syndicate structure. Presumably, the client carefully considers the costs associated with syndication when it chooses this form.

organization costs against external syndication costs. For any given distribution of jobs, some degree of syndication is more efficient than having firms capable of doing any kind of project. Placing all of an industry's input resources into one large firm can cause costs to be higher than spreading them out over several firms and using syndication to complete big projects. Larger, more diverse firms incur diseconomies of scale and scope. Generally, syndication causes firms to economize on firm organization costs, allowing smaller, "boutique" firms. In the legal profession, patent law presents a good example of an area where syndication among firms might be prevalent.²⁷

However, firms' optimal structures are highly interdependent, so that a shock to one firm that causes it to revise its structure will in turn impact the other firms' optimal structure. These shocks may arise from many sources, but we focus on three different types of changes: a shift in the size of the job, changes in other firms' sizes or cost structures, and alterations in the existing legal regime. For example, if jobs become larger over time as a result of clients' needs, then an accounting firm may choose to expand to handle each job internally. The larger organization costs it incurs from employing more inputs may be more than offset by the increase in revenues from being able to staff the job in-house, especially if the larger accounting firm will gain more clients after its expansion.

The existence of syndication makes equilibrium industry structure even more sensitive to external shocks. A shock that has the direct effect of reducing syndication opportunities will have a secondary effect as well: as the firms move to restructure themselves, the opportunities for mutually beneficial syndication can be further reduced. For instance, the first accounting firm to expand will have an advantage in seeking to land the bigger jobs being offered by clients, but this expansion will also have several secondary effects. The newly expanded firm will now be less interested in engaging in syndicates with the other firms. The other firms may believe that the expanded firm is earning more profit by itself on bigger jobs than they are in syndicates. All of these factors may lead the remaining (smaller) firms to seek to grow larger, either internally or through

27. Although patent law firms have been consolidating in recent years, patent prosecution is still an area that remains attractive as a specialty area for a boutique firm. Well-known firms such as Fish & Neave (New York), Pennie & Edmonds (New York), Fish & Richardson (Washington, D.C.), Merchant & Gould (Minneapolis), and Finnegan, Henderson, Farabow, Garrett & Dunner (Washington, D.C.), are just a few of the independent specialty patent firms.

mergers. Firms that choose not to expand may pay a price. For example, one of the best known international investment banks, J.P. Morgan, had been left on the sidelines in the lucrative underwriting and merger-advisory business because of its relatively small size and refusal to merge with its rivals.²⁸ It was eventually acquired by Chase Manhattan Bank.²⁹

Our key empirical assertion is that, in the last twenty years, clients have increasingly demanded large projects.³⁰ This increased demand has shifted the historical equilibrium between syndication and internal size, and has triggered internal growth by service providers. The increased demand for large projects comes from increased globalization of clients and the explosion in information technology. In addition, and in part to exploit more fully the efficiencies of the new technology, clients increasingly want one-stop shopping.

In some industries—accounting and law are good examples—clients traditionally asked firms to provide them with a limited set of services on a local basis. Over the past thirty years, clients have shifted toward asking firms to provide them with more and more services on a broader and broader geographic basis. For example, globalization has led many clients to ask firms to handle increasingly complex transactions across international borders.³¹ Changes in information technology have reduced the costs of internal growth and contributed to this trend toward larger firms by breaking down communication, time, computing and other barriers that previously constrained the size and scope of transactions.³² Clients can therefore ask service firms to handle increasingly complex deals. In the face of these changes, firms are increasingly choosing growth over syndication.³³

28. See Jathon Sapsford, *J.P. Morgan May Be Value Play It Aims to Match Street Rivals*, WALL ST. J., Aug. 17, 2000, at C1.

29. See Randall Smith & Charles Gasparino, *Merger Question on the Street is 'Who's Left?'*, WALL ST. J., Sept. 13, 2000, at C1.

30. This empirical assertion is frustratingly hard to document. See *infra* notes 65–67 and accompanying text.

31. Patrick E. Mears & Carol M. Sanchez, *Going Global: How Do Law Firms Do It and What Does It Change?*, BUS. L. TODAY, Mar./Apr. 2001, at 32, 32–34.

32. For example, with technology only recently available, Morgan Lewis & Bokius LLP, one of the ten largest law firms in the world, utilizes a high-capacity, private email system to connect its approximately 2,500 lawyers and staff in twelve offices across the globe to collaborate with each other and to communicate with clients around the clock. Stanley M. Wasyluk, *Keeping Your Attorneys in Touch at All Times*, LEGAL TECH NEWSL., Dec. 2000, at 5.

33. We emphasize that this is only a trend and that there are many firms which have

We see an increased demand by clients for one-stop shopping³⁴ for their legal, investment banking, and other professional services' needs, triggering industry-wide consolidations.³⁵ The financial services industry is a recent example of this process. Smaller firms, such as boutique investment banking firms, lack the necessary capital and scale to compete with larger ones, such as full service banks, to meet the demands of big international clients.³⁶ Thus, in the recent initial public offering (IPO) of Agere Systems Inc., which is being spun off by parent Lucent Technologies, the company selected its underwriters based on whether they were willing to lend Lucent and Agere substantial amounts of money as part of the \$6.5 billion Lucent restructuring.³⁷ Only commercial banks that had acquired Wall Street investment banks had strong enough balance sheets to lend Lucent the hundreds of millions of dollars that it demanded as the price of participation in the IPO underwriting. This one-stop shopping led to the exclusion of pure investment banking firms such as Goldman Sachs Group Inc. and others.³⁸

The result was a tremendous amount of merger activity within that industry, as independent firms have rushed to achieve greater scale. Donaldson, Lufkin & Jenrette, J.P. Morgan, PaineWebber, and

not pursued growth strategies for a wide variety of reasons. On the international side, some types of jobs may be more suitable for one firm to handle rather than for a syndicate. For example, asset securitizations in Europe may involve a dozen different jurisdictions, but are usually handled by one law firm (usually Clifford Chance). But with other types of deals with only two or three different jurisdictions, where the investment bankers have good local connections with local law firms, the transaction costs of syndication may be much lower and the job may be handled by a group of firms.

34. To the best of our knowledge, no one has yet documented the increase in demand for one-stop shopping empirically. In Part II.B, we attempt to do so on a preliminary basis for the demand for legal services in the mergers and acquisitions area. We believe that more work needs to be done to quantify this shift. However, the forces that have led many clients to demand such services are well-known: increased quality of work product, increased efficiency in provision of services, and decreased costs. John S. Dzienkowski & Robert J. Peroni, *Multidisciplinary Practice and the American Legal Profession: A Market Approach to Regulating the Delivery of Legal Services in the Twenty-First Century*, 69 *FORDHAM L. REV.* 83, 117-27 (2000); Tia Breakley, Note, *Multidisciplinary Practices: Lawyers and Accountants Under One Roof?*, 2000 *COLUM. BUS. L. REV.* 275, 297-301. For further discussion of this point, see *infra* notes 65-67 and accompanying text.

35. For example, in the legal profession, multinational clients have welcomed one-stop shopping because they are "able to reduce substantially the number of the law firms they were dealing with, bringing about better matter management, better quality, lower legal fees, and lower overhead costs to manage their panel of outside law firms." Marc J. Bartel, *The U.S. Impact From Europe's Legal Scene*, N.Y.L.J., Apr. 14, 1998, at 5.

36. Smith & Gasparino, *supra* note 29.

37. Suzanne McGee, *Lucent Rewarded Lenders With Underwriter Roles*, WALL ST. J., Feb. 28, 2001, at C1.

38. *Id.*

Wasserstein Perella all were acquired by other banks, and Lehman Brothers and Bear Stearns are reported to be under pressure to join forces with financial services giants.³⁹ Clients, especially multinational companies, are looking for larger firms. They want to engage in one-stop shopping to get the best deals from service providers.⁴⁰

In sum, as we document in the subsequent parts of this Article, in law, accounting, and investment banking, syndication strategies have been largely eclipsed by internal growth strategies. In other words, growth and more growth are what we see today at the larger firms. The reasons behind the decline of syndication and emphasis on growth are explained by changing client demand and changes in internal organization costs. Syndication has been used historically in a variety of situations that include: (1) where additional size is needed within the same discipline for particular projects and syndication is cheaper than growth because of cost differentials (e.g., investment banking); (2) where more than one discipline is needed for a project, as with firms combining auditing and consulting or law and accounting; and (3) where more than one country, culture, or regulatory system is involved, perhaps best illustrated by the international expansion of American and U.K. law firms. As we discuss in Parts II, III, and IV, all three of these justifications have been undercut by changes in the underlying demand for these firms' services and lower costs of internal growth.

However, some limitations to these trends are emerging. Internal organization costs can reach such high levels that even highly profitable firms find it better to split up into smaller entities and engage in syndication. We find this to be a likely explanation for the disintegration of the Big Five accounting firms that have been offering both auditing and consulting services. These smaller firms may be aggressive competitors against large firms if they can form networks to share information and business with one another.⁴¹

Legal rules can also constrain growth. For instance, the legal profession's self-regulatory rules, at least nominally—and perhaps effectively—bar the creation of multidisciplinary law firms. We claim that the firms' desire to grow to meet client demands will create powerful forces in favor of changes to these rules. If clients are

39. Smith & Gasparino, *supra* note 29; *Wasserstein's Acquisition Completed by Dresdner*, WALL ST. J., Jan. 5, 2001, at C16.

40. Investment bankers have been pushing the one-stop shopping concept for many years. Bartel, *supra* note 35, at 5.

41. Jacobs, *supra* note 24.

demanding that accounting firms continue to expand to provide broader ranges of services, including legal services, our analysis leads us to predict that these rules will come under increasing pressure to change.

Conflicts rules are another powerful constraint on firm growth. Large law firms have suffered from legal rules on conflicts of interest for years that have prevented them from being on both sides of a transaction.⁴² With the upswing in merger activity among firms, and their increased size, these rules have forced firms to abandon former clients and turn down potentially lucrative business, despite ingenious solutions that some firms have devised, such as advance waivers of conflicts.⁴³ Powerful pressures have emerged to change these rules though, and the ABA has recently proposed a substantial relaxation of them.⁴⁴

Conversely, if a new legal rule is instituted that increases the relative costs of syndication versus internal expansion, firms will expand internally. The shelf registration rule⁴⁵ has had this effect in investment banking, as we will show in Part IV.

Furthermore, just as demand for professional services can increase, it can also decline. If clients stop engaging in mergers and acquisitions activity, for example, then demand for legal services for these deals will drop. While law firms may be willing to carry underutilized attorneys for quite a while, at some point we would expect to see downsizings at law firms (and other service providers) to bring firm size in line with these demands.⁴⁶ One need only read the recent daily papers on a casual basis to see stories of such retrenchments throughout the industries discussed in this paper.⁴⁷

42. See generally MODEL RULES OF PROF'L CONDUCT R. 1.7 (2001).

43. Richard B. Schmitt, *Law-Firm Mergers Create Conflict Problems—And Ingenious Solutions*, WALL ST. J., June 7, 2001, at B1. These rules, in a somewhat different form, also affect accounting firms and constrain their offering clients certain types of other services. See Part III for further discussion.

44. See, e.g., ABA Report of the Commission on Evaluation of the Rules of Professional Conduct, at xiv–xvi (2000) (summarizing proposed changes).

45. Securities Act of 1933 Regulation C—Registration General Requirements, 17 C.F.R. § 230.415 (2001) (promulgating rule permitting shelf registration).

46. There is increasing evidence that this is happening in the high tech law firms, as they engage in cost-cutting layoffs of marginal workers. See, e.g., Ann Grimes, *Silicon Valley Law Firms Retrench as Deals, Stock Portfolios Dwindle*, WALL ST. J., June 15, 2001, at B1.

47. See, e.g., David Marcus, *Fenwick & West Dismisses 32 Attorneys*, THE DAILY DEAL, Sept. 6, 2001, available at <http://www.thedeal.com/cgi-bin/gx.cgi/AppLogic+FTContentServer?pagename=FutureTense/Apps/Xcelerate/Render&c=TDDArticle&cid=TDD8006CARC> (last visited Nov. 15, 2001) (documenting Fenwick & West's recent struggles as well as charting recent layoffs at many other Silicon Valley firms) (on file with

Finally, we should note that for any given probability distribution of jobs, some firms will compete for the largest jobs, some for the smallest jobs, and others for the ones in the middle of the distribution. Client demand for services may be segmented by job size or by the service offered. We would expect that different types of firms will compete within each of these markets. For example, the demand for lawyers to handle criminal defense cases (with the possible exception of large white-collar crime cases) is likely to be quite different from the demand for legal services in mergers and acquisitions, and we would expect different types of firms to compete for those jobs.⁴⁸ Smaller firms may be more efficient for smaller jobs.

We are primarily interested in firms that compete for the very largest jobs, which tend to be the megafirms that are the focus of the rest of the paper. We argue that for these firms, a shift in client demand toward bigger projects, or one-stop shopping, will push them toward expanding firm size, or to engage in syndication, in order to meet client expectations. In the next three parts, we look at how these different industries have reacted to shifts in client demand toward increased job size.

II. THE GROWTH OF LARGE LAW FIRMS

Our project-industry model fits law firms well, since law firms work in a project-oriented industry. Generally, private-practice attorneys work on legal issues for clients in discrete matters. These projects differ dramatically in size. They may also differ along other dimensions, such as whether they involve domestic law or international issues, whether they involve the law and regulations of one jurisdiction or many, or whether they involve only one area of law or many. Complex deals frequently require firms to provide a broad variety of services. For example, a merger of two large

the North Carolina Law Review); David Marcus, *Silicon Valley Law Firm Ditches Attorneys*, THE DAILY DEAL, Oct. 12, 2001, available at <http://www.thedeal.com/cgi-bin/gx.cgi/AppLogic+FTContentServer?>

PageName=FutureTense/Apps/Xcelerate/Render&c=TDDArticle&cid=TDDCDF50PSC (last visited Nov. 15, 2001) (noting that Gunderson Dettmer was especially affected by the recent downswing in the economy because it “specializes in corporate, securities and technology work [and] has no litigation or bankruptcy [practice]”). While law firms have so far resisted layoff, “now that the downturn has finally come, the ‘L’ word is being whispered again in hallways and conference rooms [of law firms], and associates nervously await pink slips.” Cameron Stracher, *Manager’s Journal: Let the Lawyer Layoffs Begin*, WALL ST. J., May 14, 2001, at A18.

48. Much work remains to be done to improve our understanding of the different types of firm structure that have evolved in response to demand and supply-side factors in these different markets. This is a fruitful area for further research.

multinational companies may require lawyers from several different countries with expertise in securities law, tax law, environmental law, employment law, and antitrust law.

Law firms come in all shapes and sizes. As table 1 shows, the biggest American firms today employ over a thousand attorneys and have offices spanning the globe. At the other extreme, the solo practitioner continues to thrive in many parts of the country. In between these two extremes, firms cover the spectrum.

TABLE 1: Largest U.S. Law Firms
(Ranked by Revenue)

Rank	Firm Name	HQ	Revenue (Millions)	Equity Partners	Lawyers
1.	Skadden, Arps, Slate, Meagher & Flom	New York	\$1,025	292	1,322
2.	Baker & McKenzie	Chicago	818	558	2,477
3.	Jones, Day, Reavis & Pogue	Cleveland	595	274	1,213
4.	Latham & Watkins	Los Angeles	582	280	900
5.	Shearman & Sterling	New York	491	163	752
6.	Sullivan & Cromwell	New York	474	119	476
7.	Mayer, Brown & Platt	Chicago	464	306	816
8.	Davis Polk & Wardwell	New York	460	130	515
9.	Sidley & Austin	Chicago	446	260	827
10.	McDermott, Will & Emery	Chicago	445	244	784
11.	Weil, Gotshal & Manges	New York	440	160	660
12.	Simpson Thacher & Bartlett	New York	434	128	503
13.	Morgan Lewis	Philadelphia	430	290	948
14.	Gibson, Dunn & Crutcher	Los Angeles	418	219	640
15.	Cleary, Gottlieb, Steen & Hamilton	New York	412	141	525
16.	Kirkland & Ellis	Chicago	410	118	599
17.	White & Case	New York	405	183	847
18.	O'Melveny & Myers	Los Angeles	373	213	692
19.	Akin, Gump, Strauss, Hauer & Feld	Dallas	360	217	834
20.	Cravath, Swaine & Moore	New York	350	83	363

Source: AM. LAW., July 2000

The internal structure of law firms also shows a wide variety. Most firms have traditionally had two classes of attorneys: partners

that hold equity stakes, and associates that are employees at will. In recent years, the differentiations amongst attorneys have become more refined. It is now common to see larger firms employing two classes of partners, equity and non-equity, and multiple variations within each class. In addition, associates are often broken into different classes, such as special counsel, traditional associates, and contract hires. Many other attorney classifications may also exist. Law firms typically employ a number of other components of production, or in economists' terms, inputs. These may include greater or lesser numbers of professional managers (who may not be attorneys), paralegals, support staff, and other administrators.

Firms differ in their organizational forms, too. Whereas all firms were once organized as partnerships, today a host of other business entity forms are commonly used. These include the traditional partnership, Limited Liability Companies (LLCs), Limited Liability Partnerships (LLPs), and Professional Corporations (PCs). The attraction of the new entities is that they supposedly permit the equity partners to insulate themselves from some of the personal legal liabilities associated with the partnership form of organization.

Perhaps most dramatically, the size of the largest law firms has exploded in the past two decades, as shown in table 2. Historically, most law firms were domestically oriented and offered a limited set of services; local clients made limited demands on firms. Firms tended to specialize in one practice area, and called in other firms to handle cases or transactions that required several different specialties.

A. *Supply-Side Explanations of Law Firm Growth*

Legal scholars have offered several explanations for the spectacular growth of law firms. Most of these explanations focus on the needs of law firms in profitably offering quality legal services, or what we call a "supply-side" explanation.

Portfolio theory provides a basic supply-side explanation of why lawyers band together in firms. As explained in a path-breaking article by Gilson and Mnookin,⁴⁹ individual lawyers cannot diversify their human capital. By combining individual specialties within firms, law partners can eliminate the unsystematic risk of specialties, just as an investor can eliminate unsystematic risk with a portfolio of investments.

49. Gilson & Mnookin, *supra* note 1, at 321–30.

TABLE 2: Selected Major U.S. Law Firms Growth (1983–1999)

Firm	1983*			1999'		
	Number Attorneys	Number Domestic Offices	Number Int'l Offices	Number Attorneys (approx.)	Number Domestic Offices	Number Int'l Offices
Skadden, Arps, Slate, Meagher & Flom	275	3	---	1,300	8	11
Shearman & Sterling	340	1	4	700	3	10
Davis Polk & Wardwell	251	1	2	500	1	4
Sullivan & Cromwell	218	1	2	450	2	6
Baker & McKenzie	622	3	24	2,450	9	50 [§]
Sidley & Austin	308	3	6	850	4	4
Jones, Day, Reavis & Pogue	301	4	---	1,200	10	10 [§]
Vinson & Elkins	318	2	1	550	4	4
Gibson, Dunn & Crutcher	278	6	4	650	10	3
Latham & Watkins	183	4	---	950	9	5

* 1983 data are taken from the AMERICAN LAWYER GUIDE TO LEADING LAW FIRMS 1983–84.
 † 1999 data are taken from LAW FIRMS YELLOW BOOK, Summer 1999.
 ‡ Not including one correspondent law firm and one affiliated consulting firm.
 § Not including one foreign affiliated law firm.

Tournament theory has become the dominant explanation of the growth of law firms, again from the supply side.⁵⁰ In an influential study,⁵¹ Galanter and Palay document the exponential growth of large law firms. Their explanation has two parts. First, experienced lawyers have more client work than they can personally handle (a phenomenon they later label “Big Client Trust”).⁵² They therefore hire associates to leverage their own human capital. But second, the experienced lawyers must monitor and motivate the associates, which

50. See the opening sentence of Wilkins & Gulati, *supra* note 1, at 1581 (“Tournament theory has become the dominant academic model for analyzing the institutional structure of large law firms.”).

51. MARC S. GALANTER & THOMAS M. PALAY, *TOURNAMENT OF LAWYERS: THE TRANSFORMATION OF THE BIG LAW FIRM* 77–120 (1991); Marc S. Galanter & Thomas M. Palay, *Why the Big Get Bigger: The Promotion-to-Partner Tournament and the Growth of Large Law Firms*, 76 VA. L. REV. 747, 755–56 (1990).

52. Marc S. Galanter & Thomas M. Palay, *A Little Jousting About the Big Law Firm Tournament*, 84 VA. L. REV. 1683, 1684 (1998) (“[T]he *sine qua non* of the large law firm . . . is the trust of the client (or clients) who can furnish more work than a single lawyer can possibly do. . . . Let’s call it Big Client Trust or BCT.”).

they do by running a promotion-to-partnership tournament. As long as firms keep a constant percentage of tournament winners (the associates who get the prize of partner), and a constant partner-to-associate ratio, the mathematical result is exponential growth.

Tournament theory has its critics. For example, Wilkins and Gulati note that the tournament is not a meritocracy like a tennis tournament, but more like a multi-round skating event where multiple factors determine the winners.⁵³ They would add signaling theory and relational capital stories to provide a richer model of the internal labor market of law firms.⁵⁴ Their more contextualized model explains why law firms develop training and paperwork tracks for associates and why some associates have presumptions in their favor (are seeded in the tournament). But Wilkins and Gulati's rich story remains a supply-side one, focusing on the needs of law firms to produce the product rather than responding to client demands.⁵⁵

Rutherglen and Kordana would go further and abandon tournament theory altogether as the key element of the modern law firm.⁵⁶ The leveraging of partners' human capital and the competition between firms for associates are sufficient. Intriguingly for our demand-side perspective, Rutherglen and Kordana note that tournament theory "does not address the increased demand for the services of large law firms, which must have accompanied their increase in size."⁵⁷ Finally, they say, tournament theory does not explain the recent trend toward increasing law firm size by hiring partners laterally or, even more dramatically, by merging entire firms.

In all these supply-side theories, a firm's growth is limited by the agency costs associated with governing a large group of people. Large, integrated law firms incur greater internal organization costs than smaller specialty firms. These costs arise in part from the greater number of inputs employed by the big firms, including the attorneys and other workers, as well as the bigger offices and higher resulting overhead costs. These entities are also harder to manage, so that more attorney time is eaten up handling firm management questions, and professional managers may need to be hired.

Internal organizational costs should increase with the size of the

53. Wilkins & Gulati, *supra* note 1, at 1677.

54. *Id.* at 1589-90, 1656-57.

55. *Id.* at 1587-91.

56. George Rutherglen & Kevin A. Kordana, *A Farewell to Tournaments? The Need for an Alternative Explanation of Law Firm Structure and Growth*, 84 VA. L. REV. 1695, 1705 (1998) ("[W]e now must go beyond tournament theory . . .").

57. *Id.* at 1703.

firm (scale) and also with the mix of inputs that it uses (scope). For example, a small specialty firm that has only one practice area, perhaps tax or patent law, should be easier to manage than a larger firm that offers its clients a full range of legal services. The larger firm's size and diversity of legal specialties make it more difficult to manage effectively.

Our model accepts these supply-side explanations, without the need to referee which model or combination of models best explains the internal structure between partners and associates of law firms. Rather, our goal is to explain the overall size of law firms, and in particular the spectacular growth of the largest firms and the limits on that growth. From the supply-side models, we emphasize that agency costs place upper limits on internal size. Even the tournament champions, Galanter and Palay, recognize that growth has its limits, and that the internal agency costs of coordinating the players must at some point outweigh the value of continuing the tournament.⁵⁸ Our perspective emphasizes that the varying size of legal projects—a demand-side explanation—is a critical factor in the size of law firms. A law firm wanting to service exceptionally large projects always has an alternative to expensive internal growth, which is relying on a network or syndicate of firms to handle the exceptionally large projects.

B. Demand-Side Explanations for Law Firm Growth

The demand for legal projects is a key element in determining the optimal size of a law firm.⁵⁹ A firm wants to be large enough to capture a steady stream of large projects, but does not necessarily want to be large enough to handle the largest projects, particularly if

58. The image that comes to mind with an exponentially expanding firm is a Ponzi scheme, where one does not want to be the frustrated associates holding the bag when the bubble bursts. Cf. *Cunningham v. Brown*, 265 U.S. 1, 7 (1924) (describing the "remarkable criminal financial career of Charles Ponzi," giving rise to bankruptcy litigation reaching the U.S. Supreme Court); Stephen A. O'Connell & Stephen P. Zeldes, *Ponzi Games*, 3 NEW PALGRAVE DICTIONARY OF MONEY & FINANCE 147, 147 (1994) (describing how Ponzi operated "a financial chain letter, using funds from new investors to pay off earlier investors").

59. In examining how the legal profession restricts strategic litigation through ethical rules, Professor Gilson has likewise distinguished supply-side from demand-side stories and recognized the paucity of demand-side explanations of legal practice. See Ronald J. Gilson, *The Devolution of the Legal Profession: A Demand Side Perspective*, 49 MD. L. REV. 869, 916 (1990) ("The study of professionalism by lawyers and sociologists has been dominated by a myopic, albeit understandable, focus on the supply side of the traditional market for legal services."). Professor Gilson does not use the demand-side perspective to explain law firm growth, however.

they arise infrequently. Rather than incur the long-term fixed costs of size, a better strategy might be to share the work of exceptionally large projects with other firms, in some form of syndicate. As clients change their demand for legal projects, the optimal balance between syndication and internal growth changes as well.

The future demand for legal projects is uncertain. Cases arise depending upon financial and economic variables, government action, and filing of suits by individuals. At best, firms can only project the probability distribution for the jobs that will arise in the future. The boom and bust mergers and acquisitions cycle of the 1980s and 1990s is a good example of the changing probability distribution of legal projects. For most of the 1980s, law firms were expanding their mergers and acquisitions practices as rapidly as they could to handle seemingly endless demand for their services. However, in the late 1980s and early 1990s, merger activity dropped off and significant retrenchment took place in these departments at many law firms, with lawyers being reassigned or even dismissed. Not until client demand picked up again later in the decade did law firms respond by once again expanding their mergers departments to staff many big deals. The bust phase of the cycle reappeared in 2001.⁶⁰

Syndication works well for short-run boom and bust cycles.⁶¹ Syndication permits law firms to share work amongst each other in response to the demand for large projects, without incurring long-term costs of growth. One form of syndication has smaller, specialized law firms working together (or with larger firms) for clients who need advice on several aspects of their business. Syndication is also common for complex business deals, especially for international transactions. For example, international mergers are

60. Many attorney layoffs witnessed in 2001 at some large law firms were "in capital markets or mergers and acquisitions departments, [therefore] reflecting the reality that deal flow . . . quickly [dried] up." Sandra Rubin, *Sober Times at the Bar: A Cloud of Doom Hovers Over Practices Across North America as Hefty Salary Increases and Bonuses Get a Second Look and Firms Position Themselves to Counter Declining Revenue*, NAT'L POST, Nov. 7, 2001, available at 2001 WL 29558801 ("The New York law firm of Shearman & Sterling decided recently to cut up to 10% of its associates, becoming one of the first tier-one transactional firms to acknowledge it has been significantly affected by cutbacks by its larger corporate clients.").

61. We note that syndication with other firms is not the only possible response to sudden changes in demand. Firms appear to be increasingly using contract associates and temporary attorneys to handle certain types of cases. The expansion of this type of hiring would blur the traditional boundaries of law firms and give the firm another alternative to internal growth or expansion. However, if there has been an increased use of contract associates and temporary attorneys, it has not stopped the rapid expansion of megafirms. For example, we continue to see large numbers of mergers and acquisitions among these firms.

often handled by several law firms from different countries serving the same client on a coordinated basis.

When demand for large-scale projects shifts, however, the calculus between syndication and growth also changes. When large projects are episodic, it is inefficient for a single firm to incur the internal growth costs required to handle one by itself. The risk that resources will remain idle, or have to be laid off, is large. But when large projects become more routine, it is more cost effective to grow internally. As a leading firm or two grows to service the large projects, the remaining firms have fewer opportunities to syndicate. They are then forced to respond by internal growth themselves, rather than relying on syndication.

Indeed, firms do not always wait for actual demand to shift, but may also respond to anticipated demand. For example, the law firms White & Case and Clifford Chance have opened offices in countries where there is presently little client demand, but where they anticipate such demand will arise in the future.⁶² This demand may not materialize, in which case these firms may need to reduce or eliminate their investments. This is consistent with our model's predictions that firms will change their employment levels if their internal organization costs are not covered in equilibrium.

Our basic demand-side explanation for law firm growth is the explosive increase in the demand for large, complex projects. As one well-known commentator noted recently: "Increased regulation of the economy . . . , a robust economy, and an unprecedented increase in the number and size of both domestic and international transactions, and a comparable increase in the volume and scope of litigation have all increased the demand for, and the resulting supply of, lawyers."⁶³ As business corporations have grown in size and geographical scope, they demand larger legal projects, and law firms respond to this increased demand by growth and merger.⁶⁴

Of course, not all clients started generating such projects. Many large corporations continue to select a top-tier law firm in each country—irrespective of size—to handle their particular problems in

62. Wade Lambert, *Doing Business In Vietnam Has Pitfalls*, WALL ST. J., Feb. 11, 1994, at B5 ("U.S. law firms see a rising demand for their own services in Vietnam."); see also Konstantin Richter, *Singapore Eases Access for Lawyers from U.S., U.K.*, WALL ST. J., Aug. 11, 2000, at A12; *Vietnam to Award 6 Foreign Law Firms Branch Licenses*, WALL ST. J., May 13, 1996, at B5.

63. Daniel R. Fischel, *Multidisciplinary Practice*, 55 BUS. LAW. 951, 969–70 (2000).

64. Mears & Sanchez, *supra* note 31, at 32 (explaining that the globalization of business has led to "a sea change" in the legal industry).

that nation. Nevertheless, the probability distribution of demand shifted toward larger jobs because more clients started making these demands. Demand changes at the margin can have a large influence on a law firm's structure as they compete for additional business, even while trying to serve existing clients in traditional ways.

Client demand for legal services is not an easily observed variable. While clients and firms often cite the need for one-stop shopping in discussing the future of legal service providers, we are forced to infer facts about actual demand from other data. Mergers and acquisitions is perhaps the best illustration of the shift in client demand. Increased law firm job size can be inferred from data on the growth in the number, value, and size of mergers and acquisitions. Figures 1 and 2 illustrate the number of proposed mergers in the United States and their value from 1990–2000. These figures are based on filings made by companies seeking clearance from federal regulatory authorities for potential antitrust violations. They show a clear upward trend in both the number, value, and size of the proposed mergers. The average value per proposed transaction also rose substantially over this time period from \$134 million in 1990 to \$413.2 million in 1999.⁶⁵

Turning next to table 3, we see that similar trends exist for completed mergers during the period 1980 through 1999. There is a clear upward trend in the number of transactions, their value, and the average value per deal. There also appears to be a large upswing in the number of big deals valued at more than one billion dollars. From these data showing more mergers with bigger dollar values, we infer an increased demand for bigger projects and that larger teams of attorneys will be needed by the firms that handle them. This inference is supported by anecdotal evidence of client demand for these services.⁶⁶

We do not claim that these data constitute an ideal measure of increased client demand for bigger jobs.⁶⁷ There are several flaws in it. For example, it may be the case at some firms that each deal is staffed by the same number of lawyers irrespective of its size, so

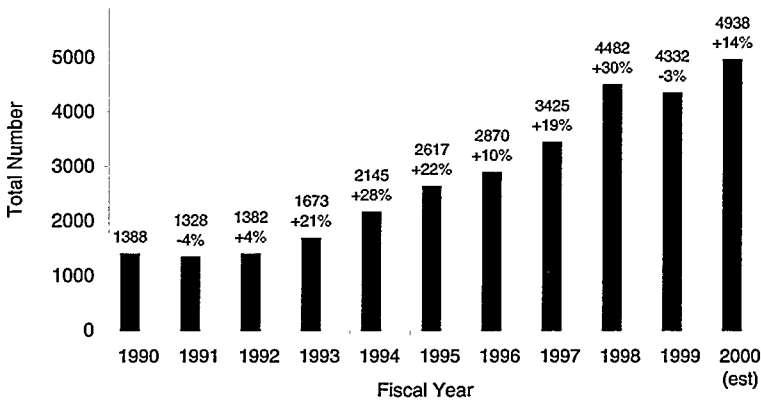
65. The average values for each year in figures 1 and 2 are: 1990, \$134 million; 1991, \$103 million; 1992, \$108 million; 1993, \$142.8 million; 1994, \$166.4 million; 1995, \$191.8 million; 1996, \$229.6 million; 1997, \$280 million; 1998, \$359.8 million; 1999, \$413.2 million.

66. See, e.g., Bartel, *supra* note 35.

67. An ideal measure could be constructed through a microlevel study of each individual firm to sort out the individual contributions of supply-side factors and demand-side factors. This suggests an important area of future research for legal and sociological study.

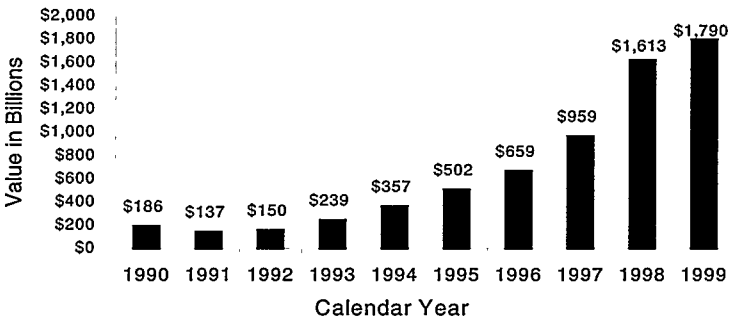
bigger valued deals may not increase demand for legal services. Another problem is that deal value may also be increasing because of changes in stock prices resulting from general market increases during this time period. So it might be true that deals are no bigger today than they were ten years ago once market conditions are taken into account.

Figure 1: Number of Proposed Mergers in United States (1990–2000) Hart-Scott-Rodino Premerger Filings*



* Chargeable filings. Data does not include transactions for which notice must be given but no filing fees are required, such as those subject to approval by federal regulatory agencies. Source: 1999 U.S. DEP'T OF JUSTICE, ANITRUST DIV. ANN. REP. 10.

Figure 2: Value of Proposed Mergers in the United States (1990–2000)



Source: U.S. DEP'T OF JUSTICE, ANITRUST DIV. ANN. REP. 11.

Undoubtedly, these factors will need to be taken into account before client demand for legal services can be accurately measured on

a disaggregated basis. However, we believe these data suggest an upward trend in job size that is also consistent with clients' statements that they are interested in one-stop shopping and that is consistent with the increased globalization in the mergers and acquisitions area that we discuss below.

TABLE 3: Completed Mergers (1980–1999)

Year	Number of Deals	Value of Deals (millions) (when reported)*	Number of Deals with Price Data	Average Value per Deal†	Number of Billion (\$) Dollar Deals
1980	1,558	\$34,829.9	N/A	N/A	N/A
1981	2,328	69,524.4	N/A	N/A	9
1982	2,298	60,697.8	N/A	N/A	10
1983	2,339	51,890.9	1,017	51.02	6
1984	3,064	125,228.8	1,476	84.84	19
1985	3,397	144,283.5	1,620	89.06	26
1986	4,323	204,438.9	1,970	103.78	31
1987	3,920	177,203.3	1,907	92.92	30
1988	4,001	236,424.3	1,904	124.17	42
1989	3,766	245,431.0	1,930	127.17	35
1990	3,154	164,293.3	1,048	156.77	37
1991	3,446	141,460.5	1,073	131.84	21
1992	3,678	124,787.7	1,340	93.13	17
1993	4,042	170,349.8	1,561	109.13	29
1994	4,923	280,400.0	1,893	148.12	44
1995	6,209	375,000.0	2,383	157.36	75
1996	7,077	656,500.0	2,892	227.01	101
1997	7,834	791,300.0	3,449	229.43	136
1998	10,092	1,342,800.0	4,263	314.99	185
1999	8,695	1,393,900.0	3,433	406.03	N/A

* Value data are not reported for all transactions.

† Calculated using data on mergers where data on price were reported.

Source: MERGERS & ACQUISITIONS: DEALMAKER'S J. (various issues).

Bigger jobs can also demand a broad array of services from firms. A larger law firm not only can offer clients more attorneys, but also a broader variety of services. It provides clients not only specialized legal advice, document preparation, and litigation services, but also helps them prepare proposed administrative regulations, draft legislation, or perform lobbying services. It can operate on a local, national, or international scale. Today, large American law firms "have developed the capacity to analyze and compare different and competing legal orders, and develop strategies through which their clients can benefit from the legal diversity and

complexity inherent in a federal system of law.”⁶⁸

Rapidly changing information technology is also creating pressure to expand law firms. Smaller firms are disadvantaged in the competition to attract clients by the substantial up-front expenses associated with continually updating their information technology services to compete with the bigger firms, then having to spread their higher costs over a smaller client base.⁶⁹ This creates pressure to expand, or merge with a competitor, in order to lower these costs and increase the number of matters so that the technology can pay for itself.

Skadden, Arps, Slate, Meagher & Flom (Skadden, Arps) provides an interesting illustration of law firm growth and development. Initially a very small firm, it grew rapidly as its leader, Joseph Flom, became well-known in the corporate takeover field in the 1970s.⁷⁰ By the time that mergers and acquisitions activity mushroomed in the 1980s, Skadden, Arps was established as one of the top firms in the area. It used this position to leverage itself into many other related practice areas and quickly grew until it reached its current position as one of the largest firms in the world with a diversified portfolio of practice areas spread throughout the world.⁷¹ While some of Skadden, Arps’s growth came through associate-to-partner promotions, as tournament theory would suggest, much of it did not. Rather, it involved acquisitions of groups of lateral partners in new practice areas who would bring clients with them.

Skadden, Arps’s development from a firm that largely handled mergers and acquisition work, leaving clients to look elsewhere to meet their other needs, into a diversified megafirm providing one-stop shopping for clients, can be explained using our model. While it initially operated with other firms in syndicates, offering clients only mergers and acquisitions advice, over time Skadden, Arps reacted to client demand for more services by first expanding into more

68. David M. Trubek et al., *Global Restructuring and the Law: Studies of Internationalization of Legal Fields and the Creation of Transnational Arenas*, 44 CASE W. RES. L. REV. 407, 423–24 (1994).

69. Mark Pruner, *The Internet and the Practice of Law*, 19 PACE L. REV. 69, 88 (1998).

70. LINCOLN CAPLAN, SKADDEN: POWER, MONEY, AND THE RISE OF A LEGAL EMPIRE 82 (1993); John E. Morris, *Takeover Artist*, AM. LAW., Dec. 1999, at 61 (“With his perennial foil, Martin Lipton of Wachtell, Lipton, Rosen & Katz, Flom defined the takeover field and saw it through to its climax in the 1980s.”).

71. Morris, *supra* note 70, at 61 (“By 1978 the firm [Skadden, Arps] had grown to 160 lawyers, with two-thirds of its revenue from the M&A practice. Without foresight, Skadden, Arps might have remained an M&A boutique. But in the 1980s Flom shrewdly leveraged that franchise into a full-service operation.”).

domestic practice areas, and then internationally to open offices in other countries.⁷² In short, Skadden, Arps stopped using syndication as a method of obtaining additional inputs in favor of a growth strategy in response to client demand that it provide a broader set of services.⁷³

Just as Skadden, Arps grew to take advantage of the client demand for integrated services outside the mergers and acquisitions area, many other rival large law firms acted (or reacted) in the same way. As shown in table 1, law firms have increased their size and the number of their offices to handle these mega-transactions. For big clients, and big cases, firms need resources and a diversified portfolio in order to have the necessary staying power to handle these transactions.⁷⁴ Bigger firms with diverse practices get a larger share of the market. Table 2 shows the rapid growth in size of some of the largest U.S. law firms from 1983 to 1999.

Law firms need not rely on internal growth to respond to the demand for larger projects. While internal growth might work, it is often more efficient to grow by mergers with other firms or by acquiring selected parts of other firms to fill the expanding firm's needs in certain practice areas. Mergers of law firms in different cities or countries are particularly effective in expanding a law firm's geographical reach.⁷⁵ While supply-side explanations of law firm

72. On the international front, Skadden, Arps has used some syndicate-like relationships with existing firms to offer one-stop shopping. For example, Skadden, Arps recently announced a joint venture with Chiomenti Studio Legale, one of Italy's leading firms, its "largest and most significant cross-border alliance." Steve Lipin, *Deals & Deal Makers—Italy Suits Skadden: Law Firm Will Now Join With Chiomeni—Big New York Concern Expects Larger European Presence With Preserved Autonomy*, WALL ST. J., June 12, 2001, at C12. As Skadden, Arps's European managing partner stated after the announcement, "Each firm [is] . . . desirous of preserving its own culture. But what we're trying to do is market ourselves as a seamless one-stop for investment transactions into and out of Italy." *Id.*

73. We do not claim that our model provides the only possible explanation for these changes. Supply-side factors may also explain some of the reasons for Skadden, Arps's decision. For example, the need to diversify practice areas can also be viewed through diversification models as a method of responding to the firm's partners' risk aversion.

74. Diane Goldner, *Six Branch Offices that Compete with New York's Top Tier; Latham Watkins*, MANHATTAN LAW., Jan. 19–25, 1988, at 14. In just three years Latham has become one of the most profitable firms (measured in revenue per lawyer) in New York. The firm has accomplished this by diversifying the types of projects it handles. *Id.* ("In the branch's first year of operation, 60 percent of its work was M&A related. By 1987 the amount of M&A work had dropped to 50 percent The New York lawyers plan to diversify their practice.")

75. Fischel, *supra* note 63, at 970 (explaining that client demand for larger law firms with broad geographic coverage and reduced costs of communication have led to growth of law firms); Schmitt, *supra* note 43 ("Law firms see mergers as a means to improve client

growth are embarrassed by the recent merger activity of firms, mergers become a natural way of responding to a shift in the probability distribution for future large jobs.⁷⁶

The trend toward mergers and geographic breadth is escalating in the rapidly consolidating legal industry. In 2000, a new firm, Pillsbury Winthrop, was created from the merger of San Francisco's Pillsbury Madison & Sutro with New York's Winthrop, Stimson, Putnam & Roberts.⁷⁷ In deals of similar nationwide scope, over one hundred attorneys from New York's Battle Fowler joined Los Angeles's Paul, Hastings, Janofsky & Walker, and Cleveland's Squire, Sanders & Dempsey swallowed San Francisco's Graham & James.⁷⁸ This growth was driven by the demand side, as global clients wanted a single law firm that could service all of their needs.⁷⁹ As Nick Unkovi of Graham & James explained: "Our clients are more and more demanding one-stop shopping," and it was therefore "important for us to ally ourselves with a partner who would greatly expand our geographic coverage and size."⁸⁰

Of course, not every elite corporate-law firm has expanded. Wachtell Lipton's decision to remain a relatively small, specialized mergers and acquisitions firm provides an interesting contrast to the Skadden, Arps approach. Wachtell Lipton appears to have consciously chosen to pursue a syndication strategy rather than to grow dramatically. Assuming that Wachtell Lipton faced the same set of client demands as Skadden, Arps, it may have believed that the costs of growth exceed those associated with a syndication strategy. In other words, supply-side models would explain Wachtell Lipton's choice as one of maximizing per partner profits by staying small. One important factor in the success of Wachtell Lipton's decision may be its dominant market position as the premier defense firm in the mergers and acquisitions business which ensured it would continue to obtain excellent clients. Its highly specialized practice may allow it to charge premium prices that will more than cover its higher costs of providing services, such as information technology, to its clients.

service, by expanding their practices and geographic reach.").

76. Cf. Fischel, *supra* note 63, at 970 (stating that increased demand for legal services has led law firms to expand rapidly).

77. See Michael Orey, *Two Law Firms Set to Announce Plan to Merge*, WALL ST. J., July 17, 2000, at B2.

78. *Id.*

79. *Id.* John Pritchard, chairman of Winthrop Stimson, emphasized that global forces drove his firm's recent expansions: "Our clients are globalizing, our competition is globalizing." *Id.*

80. *Id.*

International legal practice has seen an even more dramatic story of law firm growth in response to an increased demand for large legal projects.⁸¹ Here the growth versus syndication story we tell contrasts strategies of opening new offices overseas and merging with foreign firms (growth) as a way of satisfying client demand for cross-national legal services with the use of formal and informal arrangements of U.S. and foreign law firms to handle international transactions (syndication). Again, we see that the growth strategy has led to the creation of international megafirms, although some strong name brand firms continue to be very successful using syndication.

Historically, each country had its own set of legal rules and regulations and attorneys practiced solely in their own country. Many nations restricted cross-national lawyers and some restricted international law firms.⁸² Domestic firms used formal or informal syndicates with law firms in other countries to cover the international needs of their clients, such as, cross-border transactions.

The creation of the European Community, the opening of national borders between member countries, and the resultant growth in the number of businesses that operate in many countries within Europe has radically expanded the demand for large legal projects in Europe since the 1980s.⁸³ This shift in the probability distribution of jobs overwhelmed the old line European law firms, who relied on syndication to handle large projects.⁸⁴ Instead, three new groups have

81. Paul M. Barrett, *Drive to Go Global Spurs Law-Firm Merger Talk*, WALL ST. J., Mar. 18, 1999, at B1 ("Cross-border mergers are roiling practically every industry. Now the law business may be next . . . American firms . . . are nervous that over the next decade, radical consolidation in the global law industry will yield a half-dozen international titans and a lot of also-rans with shrinking profit margins.").

82. See generally CONE, *supra* note 25 (providing an extensive discussion of these restrictions); see also generally Harri Ramcharran, *Trade Liberalization in Services: An Analysis of the Obstacles and the Opportunities for Trade Expansion by U.S. Law Firms*, MULTINATIONAL BUS. REV., Apr. 1, 1999, at 27, 31-32 (analyzing the trade barriers faced by U.S. law firms abroad). Some liberalization of these restrictions has developed. Many of the most restrictive countries desire to join the World Trade Organization, putting significant pressure on them to open up their domestic markets to foreign lawyers since the General Agreement on Trade in Services applies to professional services such as lawyering. See generally, Laurel S. Terry, *GATS' Applicability to Transnational Lawyering and Its Potential Impact on U.S. State Regulation of Lawyers*, 34 VAND. J. TRANSNAT'L L. 989 (2001) (examining the effect of GATS on the provision of legal services). This may explain Singapore's recent decision to permit foreign lawyers to practice there.

83. See Ramcharran, *supra* note 82, at 35; Trubek et al., *supra* note 68, at 426; Carita Vitzhum, *Mergers Transform Europe's Law Firms*, WALL ST. J., July 22, 1998, at A11.

84. Bartel, *supra* note 35, at 5 ("Confronted with global clients' demand for sophisticated services within a specific jurisdiction and with national clients' demand for global services, Continental European law firms were forced to rethink their strategy. . . .").

stepped into the void to meet clients' needs: American law firms, the Big Five accounting firms, and a new style of European law firm.⁸⁵

American law firms gained a toe-hold in the European market during the recovery from World War II. Several firms opened, or expanded, European offices so that by the end of the 1970s, there were a number of well-established American firms in Europe.⁸⁶ These firms were in a good position to take advantage of the boom in demand for legal services that arose from the creation of the unified European market, the development of financial institutions and markets in London and elsewhere in Europe, and the wave of mergers and acquisitions in Europe during the end of the 1980s. Table 4 lists the foreign offices of the largest American law firms.

The large American law firms could offer European clients one-stop shopping for their legal services by assembling groups of specialists that could handle all aspects of a complex transaction.⁸⁷ In other words, the American firms could take on the new larger jobs that the existing European firms were too small to handle. These firms also expanded into other international markets. As table 5 shows, several American law firms, especially Baker & McKenzie and White & Case, have become major providers of legal services abroad.

Their competitors, the Big Five accounting firms, were simultaneously growing to meet the new demand for expanded sets of legal services.⁸⁸ These firms had an established niche in the European

85. Trubek et al., *supra* note 68, at 426–27; Tom Herman, *Ernst & Young Will Finance Launch of Law Firm in Special Arrangement*, WALL ST. J., Nov. 3, 1999, at B10; Jacobs, *supra* note 12.

86. Ramcharran, *supra* note 82, at 31 (“Over the recent years there has been a rapid expansion abroad of the top U.S. law firms in terms of offices located in different countries and the number of lawyers employed abroad.”); Trubek et al., *supra* note 68, at 432. Some examples include: Baker & McKenzie, <http://www.bakerinfo.com> (last visited Nov. 20, 2001) (opened Paris office in 1963 and London office in 1961) (on file with the North Carolina Law Review); Jones, Day, Reavis & Pogue, <http://www.jonesday.com> (last visited Nov. 20, 2001) (opened Paris office in 1970) (on file with the North Carolina Law Review); Mayer, Brown & Platt, <http://www.mayerbrown.com> (last visited Nov. 20, 2001) (opened London office in 1974) (on file with the North Carolina Law Review); Gibson, Dunn & Crutcher, <http://www.gdclaw.com> (last visited Nov. 20, 2001) (opened Paris office in 1967) (on file with the North Carolina Law Review); and Sidley Austin Brown & Wood, <http://www.sidley.com> (last visited Nov. 20, 2001) (opened London office in 1974) (on file with the North Carolina Law Review).

87. Bartel, *supra* note 35, at 5 (explaining that U.S. law firms were able to capture market share in Europe by offering one-stop shopping for legal services); Trubek et al., *supra* note 68, at 432–33.

88. Bartel, *supra* note 35, at 5 (stating that accounting firms entered into the competition to provide legal services in the European market with some substantial advantages); Herman, *supra* note 85 (“In other parts of the world, such as Europe, Big Five accounting firms have set up, affiliated with or acquired law firms, creating massive

legal market in providing tax advice to businesses there.⁸⁹ As the market for tax services grew, the accounting firms expanded their tax capabilities by hiring lawyers from government agencies.⁹⁰ The mergers and acquisitions wave of the late 1980s, however, really triggered the Big Five's capture of a significant share of the market for legal services in Europe.⁹¹

TABLE 4: Foreign Offices of Largest U.S. Law Firms

Rank	Firm	Locations	Total Foreign
1.	Skadden, Arps, Slate, Meagher & Flom www.skadden.com U.S. Headquarters: New York	China, Belgium,* Germany,* Hong Kong,* England, Russia,* France,* Singapore,* Australia,* Japan,* Canada	11
2.	Baker & McKenzie www.bakerinfo.com U.S. Headquarters: Chicago	Argentina, Australia, Azerbaijan, Bahrain, Belgium, Brazil,* Canada, Chile,* China, Colombia, Czech Republic, Egypt,* France, Germany, Hungary,* Indonesia,* Italy,* Japan, Kazakhstan, Mexico, Netherlands,* Philippines,* Poland, Russia, Saudi Arabia, Singapore, Spain, Sweden, Switzerland, Taiwan, Thailand, Ukraine, U.K., Venezuela, Vietnam	35
3.	Jones, Day, Reavis & Pogue www.jonesday.com U.S. Headquarters: Cleveland	Belgium, China, Germany, Italy, Switzerland, Hong Kong, Spain, U.K., France, Singapore, Australia, Taiwan, Japan	13
4.	Latham & Watkins www.lw.com U.S. Headquarters: Los Angeles	U.K., Germany, France, Russia, Singapore, Japan, Hong Kong	7
5.	Shearman & Sterling www.shearman.com U.S. Headquarters: New York	U.K., France, Germany, Hong Kong, Belgium, Singapore, Canada, China, Japan, United Arab Emirates	10
6.	Sullivan & Cromwell www.sullivan.com U.S. Headquarters: New York	U.K., France, Hong Kong, Australia, China, Japan, Germany	7
7.	Mayer, Brown & Platt www.mayerbrown.com U.S. Headquarters: Chicago	Germany, U.K., China, Japan,* Mexico,* France	6
8.	Davis Polk & Wardwell www.dpw.com U.S. Headquarters: New York	U.K., France, Germany, Japan, Hong Kong	5
9.	Sidley Austin Brown & Wood www.sidley.com U.S. Headquarters: Chicago	Hong Kong, U.K., China, Singapore, Japan	5
10.	McDermott, Will & Emery www.mwe.com U.S. Headquarters: Chicago	U.K., Russia, Lithuania (not specified which offices are affiliates, if any)	3

* Denotes an affiliate office.
Source: Nov. 2001 Firm Web sites

'multidisciplinary' firms that often dominate their field.'").

89. Trubek et al., *supra* note 68, at 434; Margaret A. Jacobs, *Hybrid Law Practices in U.S. Debated—Attorneys Weigh Accounting Firms' Desire to Move Into Legal Market*, WALL ST. J. EUROPE, May 31, 2000, at 6.

90. Matthew Goldstein, *Big Five Court Tax Attorneys: Many Make Leap as Accounting Firms Work to Expand Their Legal Reach*, CRAIN'S N.Y. BUS., Mar. 22, 1999.

91. Trubek et al., *supra* note 68, at 434-35.

TABLE 5: Largest International Law Firms Including Legal Departments of Big Five Accounting Firms (Ranked by Number of Lawyers)

Rank	Firm Name	HQ	Lawyers	Partners	Other Qual.	Offices	% Lawyers Abroad
1.	Clifford Chance / Rogers Wells / Punder	London	2,518	601	1,917	30	36%
2.	Baker & McKenzie	Chicago	2,423	556	1,876	61	79
3.	Landwell (PricewaterhouseCoopers)*	London	1,735	N/A	N/A	N/A	N/A
4.	Arthur Andersen Legal Services*	N/A	1,718	N/A	N/A	N/A	N/A
5.	Skadden, Arps, Slate, Meagher & Flom	Los Angeles	1,366	314	1,052	20	10
6.	Jones, Day, Reavis & Pogue	Cleveland	1,353	417	936	20	11
7.	KPMG*	Paris	1,264	N/A	N/A	N/A	N/A
8.	Eversheds	London	1,010	353	657	19	6
9.	Freshfields	London	991	254	757	16	43
10.	Latham & Watkins	Los Angeles	984	322	662	16	4
11.	Linklaters	London	980	230	750	16	27
12.	Morgan Lewis & Bockius	Philadelphia	964	313	651	13	5
13.	Allen & Overy	London	958	225	733	19	41
14.	Mallesons Stephen Jacques	Sydney	922	192	730	7	2
15.	Sidley & Austin	Chicago	872	411	461	10	6
16.	Ernst & Young*	N/A	954	N/A	N/A	N/A	N/A
17.	White & Case	Los Angeles	922	215	707	29	46
18.	Holland & Knight	Tampa	859	533	326	19	1
19.	Akin, Gump, Strauss, Hauer & Feld	Chicago	827	317	510	11	5
20.	Mayer, Brown & Platt	Chicago	827	317	510	11	5
30.	Deloitte & Touche*	N/A	691	N/A	N/A	N/A	N/A

Notes: The listing by LawMoney.com may understate the number of lawyers working at Big Five accounting firms. For example, a May 29, 2000 article by Geanne Rosenberg published in the *National Law Journal* reported over 3,600 lawyers at Arthur Andersen Legal Services, 3,300 at KPMG - Klegal, 1,500 at Landwell - PWC, and 800 at Deloitte & Touche. The article did not list a number of lawyers for Ernst & Young.

* Denotes Big Five accounting firm.

Source: <http://www.LawMoney.com>, July 27, 2000.

The Big Five had several advantages in meeting client demands for fuller services in the legal market.⁹² They were already providing clients with full service business planning and strategy on a worldwide basis. As they recruited big name lawyers, they were able to expand the range of services that they offered to cover all of their clients' legal, financial, and consulting needs in complex transactions.⁹³ This enabled them to provide clients with a greater spectrum of services on a more international basis than the law firms with whom they were competing. As we discuss in Part III.D below, the Big Five firms are moving to create fully integrated professional service firms, or Multidisciplinary Practice firms (MDPs), that will directly compete with other law firms. Table 5 shows that three of the Big Five have legal departments that rank among the ten largest law firms in the world, while the other two are not far behind.⁹⁴

A third player is emerging in the European legal market in response to the shift in the demand for legal services—the multinational European law firm with offices all over the continent. As the U.S. firms and accounting firms made inroads into the old style European law firms' markets, these firms were forced to rethink their business strategies.⁹⁵ New multinational firms have arisen throughout Europe, particularly through the efforts of aggressive English firms.⁹⁶ Some of this growth came through internal expansion but also a large number of law firm mergers has occurred.⁹⁷ For

92. Bartel, *supra* note 35, at 5 (stating that these advantages included their international reputation and the ability to duplicate “the successful plan and structure of their audit and consulting practices”); Jacobs, *supra* note 89 (“European corporate clients who have used the Big Five’s legal services praise the efficiency and cost savings. . .”).

93. Trubek et al., *supra* note 68, at 434; Jacobs, *supra* note 89 (explaining that accounting firms “in Europe explicitly provide a broad array of legal services, including counseling on such high-end matters as corporate finance and mergers and acquisitions”)

94. Cindy Krischer Goodman, *One Firm Fits All*, MIAMI HERALD, Mar. 14, 1999, at 1E (“Already, the Big Five are informally considered to be the world’s largest law firms.”).

95. Bartel, *supra* note 35, at 5 (explaining that as the American law firms and international accounting firms penetrated the Continental market, “[i]t was not sufficient any longer to simply be a good national law firm organized around old-fashioned principles, rules and structures”); Vitzhum, *supra* note 83 (“Europe’s legal profession . . . is facing the new reality of a unified European market and globalization.”).

96. Trubek et al., *supra* note 68, at 435–36; Jacobs, *supra* note 24 (“European firms have merged to meet competition from large accounting firms that have expanded their legal services in Europe, where lawyers have been less reluctant to combine with other businesses.”); Vitzhum, *supra* note 83 (“As barriers to trade have fallen, such foreign heavyweights such as the law firm Clifford Chance of the United Kingdom have muscled their way into the Continental market, building up strong teams of Spanish lawyers as part of broader expansions.”).

97. ABA COMM. ON MULTIDISCIPLINARY PRAC., FINAL REPORT TO THE HOUSE

example, the English firm Lovell White Durrant merged with the German firm Boesebeck Droste in January 2000 to form a new firm with about 1,050 attorneys.⁹⁸ Another union is London's Freshfields' with Germany's Bruckhaus Westrick Heller Loeber to create a law firm with roughly 2,300 lawyers with twenty-nine offices around the world.⁹⁹ These new European law firms have several advantages in their legal market, such as the ability to easily incorporate European lawyers into their practices and the European Community regulations that lower the barriers to cross-border practice for European nationals.¹⁰⁰ Table 5 again shows how these firms have moved into the ranks of the largest law firms in the world, with the English firms of Clifford Chance, Eversheds, Freshfields, Linklaters, and Allen & Overy being particularly strong competitors.

This consolidation trend has spread across the Atlantic in the last couple of years. In 1999, for example, an American, an English, and a German firm merged to create a global law firm: Clifford Chance Rogers & Wells.¹⁰¹ Several other major mergers between American and international law firms have also taken place.¹⁰² For example, Coudert Brothers merged twice with law firms from other countries: once with a Belgian law firm and once with an Australian law firm.¹⁰³ Christy & Viener, an American law firm, joined together with Salans Hertzfeld & Heilbronn, a French firm.¹⁰⁴ White & Case merged with a prominent German law firm in July 2000.¹⁰⁵ Dechert Price & Rhoads merged with an English law firm, Titmuss Sainer Dechert.¹⁰⁶

OF DELEGATES 16 (July 2000) [hereinafter REPORT TO THE HOUSE OF DELEGATES].

98. Konstantin Richter, *Legal Colossus May Be Forged Between U.K., German Firms*, WALL ST. J., Apr. 10, 2000, at A25.

99. See Freshfields Bruckhaus Deringer, at <http://www.freshfields.com/firm/en.asp> (last visited Nov. 28, 2001) (on file with the North Carolina Law Review).

100. Trubek et al., *supra* note 68, at 436.

101. John E. Morris, *The New World Order*, AM. LAW., Aug. 1999, at 92 (describing the three way merger). The merger included Rogers & Wells from the United States, Clifford Chance from the United Kingdom, and Pünder, Volhard, Weber & Axster from Germany. *Id.*

102. COMMISSION ON MULTIDISCIPLINARY PRACTICE, UPDATED BACKGROUND AND INFORMATIONAL REPORT AND REQUEST FOR COMMENTS 3 nn.14-15 (2000) [hereinafter UPDATED BACKGROUND REPORT].

103. *Today's News Update*, N.Y.L.J., Sept. 28, 1999, at 1.

104. Anna Snider, *Paris-New York Merger Breaks New Ground*, N.Y.L.J., Sept. 18, 1998, at 1.

105. See *2000 Annual Report*, at http://www.whitecase.com/annual_report_2000.pdf (last visited Nov. 21, 2001) (on file with the North Carolina Law Review) ("In July 2000, we joined forces with one of Germany's top M&A firms, Feddersen Lavele Ewerwahn Scherzberg Finkelburg Clemm.").

106. *Dechert Price & Rhoads, British Firm Plan Merger*, WALL ST. J., June 26, 2000, at B2.

Western Europe is experiencing a rash of similar mergers.¹⁰⁷

In addition to the expansion of client demand within the European Union countries, law firms have seen that the fall of the Iron Curtain and the privatization of former state-owned enterprises in Eastern Europe have created many new opportunities that provided them with incentives to open new foreign offices.¹⁰⁸ Furthermore, the rapid growth of many Asian economies and China's increased integration into the world economy have given firms motives to establish overseas offices in Asian countries.¹⁰⁹

Consistent with our theory, the driving force behind these international mergers is the increased demand by clients for legal services on a global basis.¹¹⁰ For example, Clifford Chance has stated that it wants to create one-stop shopping "capable of handling a wide variety of local, English and American law work for big companies and financial institutions through its many offices worldwide."¹¹¹ Probably the single greatest force in this shift has been the increase in mergers and acquisition activity in the European market.¹¹² In other words, a change in the size of projects expected in the future led to a change in firm structure. When one firm grew to take advantage of the potential larger jobs, its competitors felt pressure to follow suit.

While we lack data to test our claim of increased client demand for one-stop shopping outside of the mergers and acquisitions area, we see many of the same forces at work for other legal specialties. Globalization is forcing clients to consider the effects of their overseas manufacturing activities in a wide variety of countries. For instance, Nike's decision to manufacture its shoes in developing countries has forced it to become concerned with the labor laws in many of those countries as American consumers have protested its alleged abuses of its workers' rights. Bridgestone's acquisition of Firestone Tire in the United States has exposed it to products liability suits it probably could have avoided had it kept all of its manufacturing facilities in Japan. These clients want law firms that

107. See Richter, *supra* note 98.

108. Mears & Sanchez, *supra* note 31, at 33.

109. *Id.*

110. REPORT TO THE HOUSE OF DELEGATES, *supra* note 97, at 16 (stating that the mergers are a "reflection of the changes in the global marketplace for legal services and a response to competition [firms] face from MDPs in countries outside the United States").

111. Mears & Sanchez, *supra* note 31, at 39 (noting additionally that many firms are attempting to create a recognizable global brand).

112. Trubek et al., *supra* note 68, at 437. See generally Bernard S. Black, *The First International Merger Wave (and the Fifth and Last U.S. Wave)*, 54 U. MIAMI L. REV. 799 (2000) (discussing the international merger wave of the 1990s).

they know and trust to assist them with their legal disputes. While they are still often forced to use syndicates of firms to handle their legal needs, the demand for one-stop shopping seems to be growing.

Before moving on to discuss accounting firms and investment banks, we should reemphasize that our model focuses on a demand-side explanation for the emergence of megafirms. However, it remains flexible enough to explain both growth and syndication strategies that result from supply-side considerations. For example, several “name brand” firms have resisted the trend of rapid expansion through mergers and acquisitions, preferring to grow more slowly through internal labor markets, and continuing to use syndication for overseas jobs. Two outstanding examples of this are Cravath, Swaine & Moore in the United States and Slaughter and May in the United Kingdom. Both of these firms have apparently acted to maximize profits per partner, and therefore strictly limited the number of their equity partners, even at the expense of total firm revenues. This may also be true for certain “pure play” firms, such as Wachtell, Lipton, Rosen & Katz (mergers and acquisitions) and Caplin & Drysdale (tax). These firms may be able to exploit their specialized knowledge to charge their clients premium prices that allow them to cover their increased costs of remaining small, such as those associated with improved information technology. Our model would explain these firms’ decisions to prefer syndication as the result of the lower net costs of that approach, where net costs take into consideration improved revenues. Each of these firms can afford to turn down client demands for one-stop shopping because of their strong market niche.

We also do not deny the importance of noneconomic factors as complementary, and sometimes alternative, explanations of law firm structure. For example, most U.K. firms use seniority systems in determining partner compensation, whereas many American firms emphasize partner productivity. These cultural differences may lead to path dependent differences in law firm development and the choice between growth and syndication. Our point is that demand-side factors also play an important role in the choice between growth and syndication.

From the firms’ perspectives, time will tell whether growth or syndication is the best strategy. Ultimately though, the factors that we identified in Part I—internal organization costs, syndication costs, the probability distribution of jobs, and legal rules—will have a strong influence on firm structure within the legal industry.

III. SYNDICATION AND GROWTH IN ACCOUNTING

Accounting is another project-oriented service industry that fits our model well. Accounting firms vary widely in size, input resource mix, legal form, and project capabilities. The large firms have grown spectacularly in recent years. Yet some firms regularly use syndication to share work with others when clients demand specialized knowledge or other resources beyond one firm's capabilities, or when regulations prevent a single firm from offering a range of services.

A. *The Growth of the Big Eight, Six, Five*

The most striking feature of the accounting industry is the size, dominance, and rapid growth of the largest firms. As illustrated by table 6, the five largest firms, appropriately called the "Big Five," earn billions in annual revenues and employ tens of thousands of workers. The accounting giants dwarf the largest law firms, as can be seen by comparing table 1 (largest law firms) and table 6 (largest accounting firms). While some of the accounting firms' growth can be attributed to internal expansion, much of it was generated by mergers with other large accounting firms. For example, the 1998 merger of Price Waterhouse and Coopers & Lybrand created the world's sixty-first largest employer¹¹³ with combined revenue in 1999 of over \$15 billion.¹¹⁴

The Big Five have dominated auditing for many years and their market share is growing. As early as 1956, the then Big Eight firms audited over seventy percent of the corporations listed on the New York Stock Exchange.¹¹⁵ By 1988, their market share had increased to ninety-six percent of the NYSE-listed companies.¹¹⁶ Even though accounting today goes well beyond auditing, the Big Five dominate the overall industry as well. In 2000, the Big Five garnered eighty-

113. See Graeme Kennedy, *Another Merger and Then There Were Five*, NAT'L BUS. REV., July 2, 1998, at 7, available at 1998 WL 10275640. The firm's name became PricewaterhouseCoopers, eschewing the blank and the ampersand in the prior names and, in a unique move, changing the "w" from uppercase to lower case.

114. See *Stateside Success*, INT'L ACCT. BULL., Jan. 29, 1999, available at 1999 WL 13038060.

115. Jeff L. Payne & Morris H. Stocks, *More Public Accounting Firm Mergers: What Will the Impact Be?*, 57 OHIO CPA J. 31 (1998) (citing Charles W. Wooton et al., *From the "Big Eight" to the "Big Six" Accounting Firms*, OHIO CPA J. 19 (Spring 1990)).

116. *Id.* at 31.

four percent of the total revenue of the one-hundred largest American accounting firms.¹¹⁷

**TABLE 6: Largest International Accounting Firms
(Ranked by Revenue)**

Rank	Firm Name	Headquarters	Revenue (Millions)	Offices	Partners	Staff
1.	PricewaterhouseCoopers	New York	\$15,300	N/A	10,000	146,000
2.	Andersen Worldwide	Chicago	13,900	412	2,788	93,916
3.	Ernst & Young International	New York	10,900	675	6,200	58,700
4.	KPMG International	New York	10,400	825	6,790	64,510
5.	Deloitte & Touche	Wilton, CT	9,000	725	5,608	60,790
6.	BDO International	Brussels	1,601	510	1,732	12,176
7.	Grant Thornton International	Chicago	1,506	584	2,335	12,275
8.	Horwath International	New York	1,185	369	1,790	11,280
9.	RSM International	London	1,182	524	1,864	10,623
10.	Moores Rowlan International	London	1,141	603	1,884	10,717
11.	Summit International Associates	New York	898	365	1,298	6,610
12.	Nexia International	London	800	213	939	N/A
13.	PFK International	London	788	363	1,302	8,530
14.	Fiducial International	Lyon, France	750	772	N/A	9,350
15.	HLB International	London	750	420	1,200	6,500
16.	Moore Stephens International	London	669	382	1,153	7,248
17.	AGN International	London	564	325	779	4,722
18.	MacIntyre International	London	429	216	825	2,359
19.	IGAF	Chester, NJ	428	338	809	6,014
20.	BKR International	New York	401	269	740	4,213

Note: The number of partners for Andersen Worldwide seems disproportionately small, and perhaps omits consulting or another division.
Source: *Top 25 International Accounting Networks*, INDUS. WK., Jan. 24, 2000, at 44.

In the past two decades, the biggest accounting firms have expanded rapidly in scope. A generation ago, accounting firms primarily acted as auditors for clients, providing them with assistance in preparing their financial statements, and in complying with Generally Accepted Accounting Principles (GAAP). In 1977, for

117. Rick Telberg, *The Right Formula*, ACCT. TODAY, Mar. 13, 2000, available at 2000 WL 11747970 (reporting results of an annual survey).

example, auditing comprised seventy percent of all revenues of the large firms.¹¹⁸ However, auditing work has stagnated in recent decades,¹¹⁹ to the point that auditing now accounts for only thirty percent of these firms' total revenue.¹²⁰

To supplement traditional auditing work, the big accounting firms have increasingly provided management consulting services to their clients. Today, they earn more than half their revenue from consulting, up from twelve percent in 1977.¹²¹ Accounting firms, with their auditing experience, were already familiar with the intricacies of corporate operations, management reporting mechanisms, and senior personnel. With such insights and contacts, advising on how to improve information flow was a natural extension. The explosion in information technology drove corporate demand for help in implementing or improving computer systems, ranging from material requirements planning to management information systems.

Figure 3 illustrates the range of services offered by a Big Five accounting firm. Accountants have traditionally had a monopoly over the provision of auditing services, as we detail in the next part. However, they face fierce competition in providing the other services shown in figure 3 and competitors are even making inroads in auditing by using syndicates with smaller CPA firms, as we detail in the next part. As figure 3 shows, the traditional auditing base (or A&A as it is known in the industry, for auditing, accounting, and assurance services),¹²² consists primarily of compiling and attesting to financial statements of public companies registered with the SEC, as well as other businesses or government entities.

Tax work is a second substantial practice of the Big Five accounting firms. Competition in the provision of tax services comes from law firms, smaller accounting firms, enrolled agents, tax preparers, large franchisers like H&R Block and Jackson Hewitt,

118. *Accountants Should Stick to Auditing, Levitt Says*, INVESTOR REL. BUS., May 29, 2000, at 15 [hereinafter *Accountants*].

119. For example, the 133,000 persons taking the uniform CPA examination in 1996 were fewer than the 138,677 taking it in 1982, and was more than seven percent below the peak year of 1990, when 143,572 took the CPA exam. See AICPA, THE SUPPLY OF ACCOUNTING GRADUATES AND THE DEMAND FOR PUBLIC ACCOUNTING RECRUITS—1997, at tbl.26 (1998); see also Nanette Byrnes, *Where Have All the Accountants Gone?*, BUS. WK., Mar. 27, 2000, at 203 (asserting that those taking the CPA exam for the first time fell forty percent from 1992 to 1998).

120. *Accountants*, *supra* note 118, at 15.

121. *Id.*

122. See Telberg, *supra* note 117 (defining A&A in Table of Top 50 Firms as “[a]uditing, accounting and assurance services [and] includ[ing] write-ups, compilations, reviews and attest”).

computer software programs like TurboTax, and web-based tax services. The Big Five provide financial services as well, ranging from retirement planning for individuals to complex corporate consultations. Their competitors here include brokerage firms, such as Salomon Brothers and Merrill Lynch, that can leverage the work from their licenses to broker stocks, as well as financial planning firms, such as American Express.

Figure 3: The “One-Stop Shopping” Office Tower
Principle Services Offered by Big Five Accounting Firms

Main Competitors	Type of Service	Description of Services
<ul style="list-style-type: none"> • Law Firms • MDPs 	Legal	<ul style="list-style-type: none"> • Tax • Corporate Transactions • Litigation Support
<ul style="list-style-type: none"> • Big Five Spinoffs • Non-Big Five Accounting Firms • Pure Consulting Firms • E-Consultants • Any Person or Organization Offering Consulting Services 	Consulting	<ul style="list-style-type: none"> • Information Technology • Management Consulting
<ul style="list-style-type: none"> • Consolidators (e.g., AMEX, CBIZ, or H&R Block) • Non-Big Five Accounting Firms • Brokerage Firms (e.g., Salomon, Merrill Lynch) • Insurance Companies • Banks 	Financial Services	<ul style="list-style-type: none"> • Financial Planning • Investment Advice <i>With Special Licenses:</i> • Mutual Fund & Securities Sales • Insurance Sales
<ul style="list-style-type: none"> • Law Firms • Non-Big Five Accounting Firms • Consolidators • Tax Specialist Firms (e.g., Jackson Hewitt) • Enrolled Agents • Tax Preparers 	Tax	<ul style="list-style-type: none"> • Entity Tax Return Research, Preparation, and Advice • Individual Tax Returns • Tax Software • Web Based Tax Services
<ul style="list-style-type: none"> • Non-Big Five Accounting Firms • Consolidators with Accounting Firm Syndicates 	Audit and Accounting	<ul style="list-style-type: none"> • Audits of Publicly Traded Companies (SEC) • Audits of Privately Held Companies • Audits of Governmental Entities • Reviews • Compilations • Projections

Management consulting, as we have said, is the huge growth business of the Big Five firms. Consulting practices can be extremely varied, but the most lucrative area presently consists of management structure or informational technologies consulting, including the development of web sites and e-commerce. Competition is fierce here because legal regulation of providers is scant. Anyone can put up a consulting shingle.

Finally, the Big Five provide legal services, especially in tax, corporate transactions, and even litigation support. Here the Big Five are confronting the legal monopoly of lawyers on the practice of law.

The combination of legal and accounting practices is a highly contentious area that we analyze in detail in Part III.D.

The last three columns of table 7 show the relative importance to major accounting firms of the various services (lumping the top three floors of figure 3 into Management Advisory Services). These data reveal that accounting and auditing comprise only about one-third of the revenues of Big Five firms, while roughly one-half comes from consulting services. Andersen Worldwide is exceptional in earning over seventy percent of its income from consulting, although this will undoubtedly change with its split-up that we discuss in Part III.C.

Businesses increasingly demand not only a wider range of services, but larger projects as well. Companies increasingly need accounting firms with a worldwide presence. Accounting firms have responded with spectacular growth through mergers, acquisitions, and internal expansion. The consolidation of the Big Eight began in 1989, when Deloitte Haskins & Sells (itself the result of prior mergers, as were most of the megafirms) merged with Touche Ross, and Ernst & Whinney combined with Arthur Young, leaving the Big Six.¹²³ In 1998, Price Waterhouse merged with Coopers and Lybrand.¹²⁴ The result, at least for now, is the Big Five, as depicted in table 6.

Economists have struggled to explain the structure of the accounting industry. The industry is dominated by a few firms, but these firms have evolved rapidly, and there is little evidence of collusive behavior.¹²⁵ Economies of scale provide one potential explanation for the dominance of large accounting firms, and researchers have found some evidence that Big Five firms can produce lower cost audits for large clients.¹²⁶ Other scholars have suggested that the largest firms may have an advantage in giving a signal of quality, or by linking audits with advisory services or with “deep pocket” insurance.¹²⁷ The Chicago-UCLA school of industrial

123. Robert F. Reilly & Robert P. Schweih, *Financial Planning Considerations in Valuing Accounting Practices*, OHIO CPA J., Apr.–June 2000, at 36.

124. *Id.* at 36.

125. James A. Yardley et al., *Supplier Behavior in the Audit Market*, 11 J. ACCT. LIT. 151, 161 (1992) (“High concentration levels may be the result of underlying market conditions rather than collusive behavior.”).

126. *Id.* at 163 (“[E]conomies of scale may be available in the large-client market . . .”).

127. James Yardley notes that:

[T]here is little evidence that the quality of the audit opinion differs between Big 8 and other CPA firms, [but the] empirical evidence consistently indicates that type of auditor is associated with client performance. Such an association is consistent with successful signaling. However, rather than serving as a pure signal, a Big 8 auditor could assist in the achievement of client performance by

organization argues that the emergence of fewer and larger firms is simply the survival of the most efficient competitors.¹²⁸ Professors Frank and Cook insist that today's "winner take all" markets lead inevitably to fewer and more spectacularly successful winners.¹²⁹ The wide variety of theories leads one comprehensive survey to conclude that "[t]he audit market is not yet well-understood."¹³⁰

Our model can help explain the growth of the Big Five. Just as with law firms, if clients demand more and bigger jobs from accounting firms, market leaders respond to the change in the probability distribution of jobs by expanding internally to add new services, such as management consulting, and by merging with other accounting firms to provide more inputs. This enables the market leaders to capture more of these bigger jobs without syndication. The remaining firms can no longer rely on sharing work between firms, and so respond by expanding their own scale and scope through counter-mergers.

Why are the top accounting firms so much bigger than the largest law firms? Several factors explain these differences. First, the weaker legal restrictions on accountants' sale of ownership interests to non-accountants permit accounting firms to offer equity positions to non-accountants and thereby develop ancillary service businesses, such as consulting, within their firms. Law firms do not have this freedom as they are effectively limited to the practice of law.¹³¹ Second, the barriers to entry into the accounting profession are lower than in the legal profession, as it takes only 150 hours of college education (and passage of several exams) to become a CPA versus three years of post-graduate work to earn a J.D. Accounting firms should therefore have an easier time hiring entry-level workers, and leveraging their work to facilitate expansion strategies. Third, CPA audit firms serve as implicit guarantors of the accuracy of audited

providing advisory services to management or providing 'deep pocket' insurance to investors.

Id. at 169-70

128. *Id.* at 153-54 ("Analysts within [the Chicago-UCLA] school assert that monopoly is rare, weak, transient, and justified by efficiency."); see also Harold Demsetz, *Two Systems of Belief About Monopoly*, in *INDUSTRIAL CONCENTRATION: THE NEW LEARNING* 164, 177 (H.J. Goldschmid et al. eds., 1974) (noting that when industries are highly concentrated, the basic reason is the fundamental advantage of large firms in producing goods more efficiently and at a higher profit than small firms).

129. See ROBERT H. FRANK & PHILIP J. COOK, *THE WINNER-TAKE-ALL SOCIETY* 2-3 (1995).

130. Yardley et al., *supra* note 125, at 178.

131. See generally MODEL RULES OF PROF'L CONDUCT R. 5.4 (2001) (prohibiting lawyers from sharing fees or entering into business enterprises with non-lawyers).

financial statements. Mega-accounting firms have an advantage over smaller firms with respect to name recognition by investors, greater financial capital to stand behind audits, the level of expertise concerning compliance with SEC requirements, and the quality control procedures. Law firms do not serve quite the same function in the eyes of third parties nor under the federal securities laws. However, the Big Five face pressure on several different fronts as they expand their scope. Additionally, their dominance over the auditing business is being challenged by a group of new competitors who offer many of the same services.

B. *The Accounting Consolidators and Syndication*

While the Big Five typically draw the most attention, the rapid emergence of nontraditional accounting firms is equally significant, and is putting great pressure on firms within the industry. Importantly for our thesis, these nontraditional firms, which are prohibited from conducting audits, often use a form of syndication to get around legal restrictions and combine auditing services with tax, financial services, and management consulting. Explaining the structure of these upstart firms requires us to briefly sketch the regulatory rules behind audits.

Certified Public Accountants (CPAs) have a legal monopoly in audits. By statute¹³² and under SEC rules,¹³³ every publicly traded corporation must file financial statements with the SEC that have been certified by a CPA. Thus, the one person every public corporation must hire is a CPA.¹³⁴ CPAs are licensed by the states,

132. See 15 U.S.C. § 77aa(25) (1994) (requiring that a registration statement include a balance sheet “certified by an independent public or certified accountant”); *Id.* § 77aa(26) (requiring that a registration statement include a profit and loss statement “certified by an independent public or certified accountant”).

133. Regulation S-X sets forth the requirements for financial statements required to be filed under the Securities Act of 1933 and the Securities Exchange Act of 1934, including “accountant’s reports,” which are defined as “a document in which an independent public or certified public accountant indicates the scope of the audit (or examination) which he has made and sets forth his opinion regarding the financial statements taken as a whole, or an assertion to the effect that an overall opinion cannot be expressed.” Regulation S-X, Qualifications of Accountants, 17 C.F.R. § 210.1-02(a) (2001). The Commission requires that CPAs be “registered and in good standing” under the laws of their residence or principal office, 17 C.F.R. § 210.2-01(a) (2001), and that they be independent, 17 C.F.R. § 210.2-01(b) (2001).

134. SEC Commissioner, Norman Johnson, has stated that:

Auditors have a special franchise under our securities laws. They are the only experts that public companies must hire. The value of this franchise would rapidly deteriorate if auditors became just another consultant to—or advocate for—their clients. The SEC will continue to enforce independence rules to

under the guidelines of the American Institute of Certified Public Accountants (AICPA), the equivalent of the American Bar Association for lawyers.

Not only must the individual attesting to the financial statements be a CPA, but the entity he or she works for must be owned by CPAs.¹³⁵ In practice, then, only partnerships of CPAs (or the new equivalent, LLPs) can perform audits. Traditional accounting firms, including the Big Five firms, are structured as partnerships comprised principally of individuals licensed as CPAs. They hold a monopoly on auditing financial statements.

Over the past few years, financial corporations not structured as CPA partnerships have entered the consulting branch of the accounting industry. Many of these firms are publicly traded corporations, with access to immense amounts of capital. In the year 2000 ranking shown in table 7, five non-attest firms,¹³⁶ as non-CPA firms are sometimes called, were among the fifteen largest accounting firms. Two are tax-oriented companies: H&R Block and Jackson Hewitt. The other three are a new breed called "consolidators": American Express, Century Business Services (CBIZ), and RSM McGladrey (an H&R Block subsidiary). These firms offer a wide range of business and tax consulting services to mid-size businesses.

Consolidators have grown since the mid-1990s by purchasing CPA accounting firms. The consolidator keeps the tax, consulting, accounting, financial planning, and other lines of business that can be performed without a CPA license. It spins off and works in syndication with the stump CPA-only firm that continues to perform audits. In this way, the consolidators and their "captive" CPA firms can compete with the auditing and consulting services of Big Five and other CPA firms.

maintain the public's confidence in our system of financial reporting.

Norman S. Johnson, Remarks at the Securities Regulation Institute (Jan. 27, 2000), available at 2000 WL 122587, at *3.

135. AICPA CODE OF PROF'L CONDUCT R. 505 (dealing with "Form of Organization and Name"). Until 1994, it required an auditing firm to be owned only by CPAs. The relaxation of Rule 505 is discussed *infra*, at notes 146-47 and accompanying text.

136. Non-CPA firms are often called non-attest firms because they cannot attest to an audit.

**TABLE 7: Largest U.S. Accounting Organizations,
Including Non-Attest Firms
(Ranked by Revenue)**

Rank	Firm Name	HQ	Revenue (Millions)	Offices	Partners	Professionals	Employees	Fee Split		
								A&A	Tax	MAS
1.	Andersen Worldwide	IL	\$7,824	92	2,117	43,434	60,533	17	11	72
2.	Pricewaterhouse Coopers	NY	6,750	189	2,938	34,067	45,940	35	20	45
3.	Ernst & Young	NY	6,375	87	2,546	21,800	29,500	35	21	44
4.	Deloitte & Touche	CT	5,300	101	1,913	21,710	29,500	30	18	52
5.	KPMG	NY	4,656	136	1,800	16,000	23,800	35	22	43
6.	H&R Block	KS	1,267	8,923	3,361	N/A	85,596	0	100	0
7.	Century Business Servs.	OH	460	798	N/A	5,174	8,234	35	17	48
8.	RSM McGladrey	MN	381	65	369	2,217	3,383	36	31	32
9.	Grant Thornton	IL	375	48	274	2,351	3,328	41	27	32
10.	BDO Seidman	IL	298	42	335	1,438	2,358	47	28	25
11.	American Express	NY	280	63	298	2,414	3,405	40	27	33
12.	Croce, Chazak & Co.	IN	144	12	111	1,025	1,430	28	15	57
13.	Jackson Hewitt	NJ	140	3,000	626	2,550	3,549	0	100	0
14.	Plante & Moran	MI	117	17	142	780	1,250	52	26	22
15.	Moss Adams	WA	110	21	143	698	1,094	41	35	24
17.	Chitlen Gunderson	IL	96	48	117	573	1,053	43	25	32
18.	Constantin Assoc.	NY	85	6	5	698	728	5	1	94
19.	Eisnar	NY	72	3	67	301	470	38	20	42
20.	Larsen, Allen, Weisbar & Co.	MN	67	8	62	389	584	28	21	51

Note: Figures are for U.S. operations only.

Source: Rick Telberg, *Hitting New High with Heady Growth*, ACCT. TODAY, Mar. 13, 2000, at A4.

The arrangements between the consolidator and the CPA stump are complex. For example, in 1997, the partners of Checkers, Simon and Rosner, a prominent accounting firm, sold their entire practice to American Express.¹³⁷ American Express gave Checkers a license to continue to meet the attest needs of their former clients. Checkers's partners remained partners of that firm but also became employees of American Express. Former Checkers employees became employees of American Express, but were leased back to Checkers as needed to perform attest services.¹³⁸ The purchase was structured so that Checkers maintains some financial independence. Checkers can price

137. Dan L. Goldwasser, *Independence in a Changing Accounting Profession*, CPA J., Oct. 1999, at 46, 48.

138. *Id.*

its attest services as it chooses and can hire employees from sources other than American Express. It maintains its own liability insurance coverage and has a separate bank account. Checkers's partners are responsible for training employees leased from American Express.¹³⁹

Other consolidators have created similar, complex syndications of consulting, financial, and auditing services. For instance, H&R Block is a publicly traded corporation that traditionally provided tax services to individuals and small businesses. In addition to tax, mortgage, and financial subsidiaries, H&R Block has created RSM McGladrey, a large tax, accounting, and consulting firm. It did so by acquiring McGladrey & Pullen, keeping the tax and consulting operations and affiliating them with RSM International, and maintaining the M&P partnership as a syndicated attest firm.¹⁴⁰

Perhaps a stranger entry into accounting is Century Business Services (CBIZ). It started in the waste management field,¹⁴¹ but since 1996 has become a major consolidator of accounting firms.¹⁴² Its typical pattern is to buy a midsize accounting firm in a particular city, and combine it under common ownership with other business consultants such as insurance agencies, employment benefits, and technology firms.¹⁴³ As with the other non-attest firms, CBIZ keeps the CPA firms separate.¹⁴⁴

Despite the complex legal relationships that accompany the takeover by a consolidator, the day-to-day reality of the residual CPA firm remains unchanged. In terms of figure 3, the bottom-floor auditors remain in the CPA partnership, continuing to do the attest work. Persons on the upper floors now become employees of the consolidator, but in many cases continue their working relationships with the first-floor, legally independent auditors. Undoubtedly, the complexity is costly, but necessary to counter the monopoly that CPAs have over audits. Syndication allows the consolidators to

139. *Id.* at 48.

140. *A CPA Firm Goes Public*, CPA J., Oct. 1999, at 8.

141. See generally Mary Varnac, *A Question of Credibility: Century Business Services Tries to Regain Wall Street's Trust*, CLEV. PLAIN DEALER, May 14, 2000, at 1H (providing a brief history of CBIZ starting out in the waste management field).

142. Kent Hoover, *Accounting Firms Rethink Urge to Merge*, ORLANDO BUS. J., Apr. 28, 2000, at 10.

143. See Varnac, *supra* note 141; see also Heather Timmons, *Creative Accounting at Century?*, BUS. WK., Feb. 21, 2000, at 142-43 (noting that CBIZ purchased over one-hundred such companies in two years).

144. See Michael Hooper, *Accounting Firm Offers Employees Ownership*, TOPEKA CAP.-J., June 11, 1999, available at 1999 WL 20053540 ("To get around that, consolidators have created two separate firms, one for auditing and reviews to be done by CPAs and the other firm to handle business, tax and consulting service.").

compete with Big Five firms for many of the same complex, multi-faceted projects that require auditing and consulting expertise.

Again, our model offers a convincing theory for why these firms have developed in this manner. Clients want one-stop shopping to meet their financial, tax, consulting, and auditing needs. Legal regulations require non-accounting firms, especially publicly held ones, to find a partner that can supply auditing services. The non-attest companies use syndication with captive CPA firms to offer these services. Syndication becomes their preferred strategy because they are prohibited from owning their own accounting businesses. Thus, syndication acts as a way of circumventing legal restrictions on creating a single firm, rather than a mechanism for obtaining more resources. Part III.D demonstrates how the Big Five have developed a similar strategy as part of their approach to entering the legal industry.

C. *Divorce of Big Five Auditing and Consulting Services*

Traditional auditing firms are restricted to the partnership or LLP form of governance by the requirement that only independent CPAs conduct audits. While enjoying their monopoly status for audits, in recent years the traditional auditing firms have complained that their governance restrictions harm them in the lucrative consulting market, where they must compete with unrestricted and well-financed consultants.¹⁴⁵ In particular, consultants and accounting consolidators that are publicly traded corporations have ready access to capital through the stock market, which the traditional auditing firms cannot tap.

The 1990s saw a loosening of the CPA partnership requirements. In 1994, the AICPA modified Rule 505 of the Code of Professional Conduct, so that CPAs need only hold two-thirds of the ownership interests in their audit firm provided that the other owners are also actively engaged in providing services to firm clients.¹⁴⁶ The Uniform Accountancy Act, promulgated in 1997, would reduce the CPA ownership requirement to a mere one-half.¹⁴⁷ As the ownership

145. See Gerald M. Ward, *The Big-Five Battle: CPAs and Non-CPAs Square Off [On] Auditor Independence*, FIN. EXECUTIVE, Jul.-Aug. 1998, at 32, 33.

146. LARRY P. BAILEY, 1999 MILLER GAAS GUIDE: A COMPREHENSIVE RESTATEMENT OF STANDARDS FOR AUDITING, ATTESTATION, COMPILATION AND REVIEW (Harcourt Brace Professional Publishing 1999).

147. UNIFORM ACCT. ACT § 7(c)(1) (1999). Section 7(c)(1) of the Uniform Accountancy Act now calls for simple majority ownership:

Notwithstanding any other provision of law, a simple majority of the ownership

restrictions have eased, the Big Five firms have shared ownership with non-CPA partners, particularly from the consulting divisions.

Powerful forces, however, are seeking tighter restrictions on auditors, demanding a high level of independence. The SEC has long railed against non-CPA ownership of U.S. auditing firms and combining auditing and consulting services.¹⁴⁸ The SEC forcefully argues that U.S. dominance as the world's leader in financial markets arises in large part because of the transparency and integrity of its financial reporting system.¹⁴⁹ It believes that relaxation of the ownership requirements will erode the public trust in auditor independence to the point where American securities markets could lose their dominance.

To accompany its dramatic rhetoric, the SEC offered several initiatives to restrict non-CPA ownership.¹⁵⁰ Responding to a recommendation from the General Accounting Office, in May 1997 the SEC and AICPA jointly created the Independent Standards Board to "unify, maintain, and improve independence standards" for external auditors of SEC registrants.¹⁵¹ One-half of the board's sixteen members are non-CPA public members. The SEC also proposed revisions of the independence requirements of Regulation S-X.¹⁵² The SEC proposal mentions twenty-five percent as a possible

of the CPA firm, in terms of financial interests and voting rights of all partners, officers, shareholders, etc., must belong to individuals licensed as CPAs in some state and the partners, officers, shareholders, etc., eligible for licensure as CPAs must be licensed in the state in which they have their principal place of business and perform professional services.

Id. § 7(c)(1). As of March 1999, at least forty-five states had adopted the Uniform Accountancy Act and its relaxed ownership standards for auditing firms. *Forty-fifth State Signs up to Uniform Accountancy Act*, ACCT., Mar. 1, 1999, at 5.

148. Regulation S-X declares that an accountant will be considered not independent if he, his firm, or any member of his firm has "a direct financial interest or a material indirect financial interest" in the firm being audited. Regulation S-X, Qualifications of Accountants, 17 C.F.R. § 210.2-01(c)(1) (2001).

149. Lynn E. Turner, Remarks at the 27th Anniversary Securities Regulation Institute (Jan. 27, 2000), available at 2001 WL 101317, at *1 (speaking on the shifting paradigms in self-regulation).

150. See Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. 43,148 (proposed July 12, 2000) (to be codified at 17 C.F.R. pts. 210 & 240), available at <http://www.sec.gov/rules/final/33-7919.htm>.

151. J. Gregory Jenkins, *A Declaration of Independence*, J. ACCT., May 1999, available at 1999 WL 9362668.

152. The SEC proposed three alternative methods of ensuring the independence of auditors: (1) Draw a bright-line by prohibiting auditors from providing any non-audit services to audit clients. Revision of the Commission's Auditor Independence Requirements, 65 Fed. Reg. at 43,173; (2) Permit an umbrella "holding entity" to own affiliated entities separated by a firewall. On one side of the wall would be an "audit entity" consisting of natural outgrowth services, such as tax and financial advising. On the

threshold. The SEC's proposals would also address a favorite technique of consolidators: leasing employees to their captive audit firms. If a captive audit firm leases personnel from an entity to perform audit services, and if that leased person performs a majority of the hours on the engagement, then the actions and interests of the leased employee are attributable to the audit firm.

In addition to the regulatory pressures to maintain independent audits, the Big Five firms face strong internal tensions that threaten to pull apart their diverse accounting and consulting operations. The most outstanding illustration of these tensions between firm branches is the battle within Andersen Worldwide. In 1989, Arthur Andersen split into an accounting unit (which kept the name Arthur Andersen) and a consulting unit (called Andersen Consulting), held together by a parent company, Andersen Worldwide (the "1989 Restructuring").¹⁵³ The 1989 Restructuring called for yearly revenue sharing by the more profitable unit, which has consistently been Andersen Consulting (AC). Indeed, AC has paid nearly \$1 billion since 1989 to its sibling, creating strong tensions between the two units. The 1989 Restructuring also allowed the accounting unit to offer its own consulting services to small companies.¹⁵⁴ In 1994, Arthur Andersen (AA) responded by creating a formal business consulting operation within the company.¹⁵⁵ By 1997, the business consulting unit was generating twenty percent of AA's total revenues. Tensions increased further when Andersen Consulting accused this business consulting unit of going after Anderson Consulting's own clients. Increasingly bitter relations between the two siblings culminated in December 1997 when Andersen Consulting formally voted to separate from Arthur Anderson. Charges and countercharges by the two firms were submitted for binding arbitration to the International Court of Arbitration in Paris. In July 2000, the arbitrator ruled that the two firms should be separated.¹⁵⁶

other side of the wall would be a "consulting entity." *Id.*; (3) Set a threshold whereby non-audit services would be deemed to impair independence only when the aggregate fees for these services (excluding tax) surpass a certain level percentage of the audit fee. *Id.* at 43,174; *see also id.* at 43,177.

153. *ICC Arbitrator Releases Andersen Consulting From Arthur Andersen & Co.*, 15 MEALEY'S INT'L ARB. REP., A-1, A-6 (citing *In the Arbitration of Andersen Consulting Business Unit Member Firms v. Arthur Andersen Business Unit Member Firms and Andersen Worldwide Cooperative*, Case No. 9797/CK/AER/ACS, ICC Int. Arb. (July 28, 2000)).

154. *Id.*

155. *Id.* at A-9.

156. *Id.*; Ken Brown, *Andersen Consulting Wins Independence*, WALL ST. J., Aug. 8, 2000, at A3.

Although Andersen Worldwide suffered the messiest divorce proceedings, it is not alone in its troubles. At least three of the other Big Five firms are planning to split their consulting and accounting practices.¹⁵⁷ PricewaterhouseCooper's has announced that its consulting firm will be spun off from its auditing group.¹⁵⁸ Ernst & Young has sold its management consulting division to Cap Gemini for an announced price of \$12 billion.¹⁵⁹ KPMG (from the names Klynveld, Peat, Marwick, and Goerdeler) has separately incorporated its management consulting services group and is selling off a twenty percent interest.¹⁶⁰

Firm partners cite regulatory pressure as a motivating factor in all the recent divestments,¹⁶¹ but we doubt that all these actions can be blamed on legal rules. For one thing, the divestments were occurring before the SEC's proposed regulations, which never became fully effective, required them. It seems unlikely that the Big Five would cave in so quickly to regulatory proposals if remaining together in a megafirm was the most profitable strategy.¹⁶²

While blaming the regulators may be convenient, we believe that something more is going on. We suspect that the internal costs of organization are very high for these megafirms, so that holding together their diverse branches is an increasing challenge.¹⁶³ Some supporting evidence is that the Andersen split began before the recent regulatory focus on independence. Maintaining a partnership where the consulting partners are consistently more profitable than the accounting partners is difficult. Using the terminology of our

157. See REPORT TO THE HOUSE OF DELEGATES, *supra* note 97, at 16.

158. See Nick Tabakoff, *Giant Firms, Small Plans*, BUS. REV. WKLY., Mar. 24, 2000, at 3.

159. *Id.*

160. Cintra Scott, *KPMG Trading White Shoes for Techie Image: Will Wall Street Buy Into Firm's Facelift Attempt?* NAT'L POST, Aug. 24, 2000, at D03; [kpmgcampus.com](http://www.kpmgcampus.com/campus/known/history/history.asp), at <http://www.kpmgcampus.com/campus/known/history/history.asp> (last visited Dec. 17, 2001) (on file with the North Carolina Law Review).

161. See John M. Covaleski, *Top CPA Firms Race to Cash Out of Tech Consulting*, ACCT. TODAY, Mar. 13, 2000, at 2; Brent Shearer, *Dealing with the Rifts at Accounting Firms*, MERGERS & ACQUISITIONS: THE DEALMAKERS J., May 1, 2000, at 3; Tabakoff, *supra* note 158, at 3.

162. See *Spoilt For Choice*, ECONOMIST, July 5, 2001, at 61, 64-65 (asserting that accounting firm divestments "had little to do with pressure from the SEC and more to do with a general realization that non-strategic [information-technology] consulting . . . sits more comfortably in an IT-centric conglomerate than it does in an accounting-oriented one").

163. Other factors may also be important. For example, conflict of interest rules may have made it difficult for accounting and consulting divisions of the same firm to sustain the high growth rates for these businesses and led to pressures to separate them.

model, the internal costs of expansion appear to have reached the point where it is more efficient for the Big Five to split up and use syndication as a means of meeting client demand for a broader variety of services. Notice that these supply-side factors led to the break-up of firms that had apparently expanded to meet demand-side client needs.

Deloitte Touche Tohmatsu appears to be alone among the Big Five in keeping its consulting practice in-house.¹⁶⁴ Its stated goal is to maintain the perceived synergies between auditing and consulting.¹⁶⁵ If large clients continue to want this one-stop shopping, Deloitte & Touche (as the U.S. national practice of Deloitte Touche Tohmatsu is known) is well-positioned to meet the demand. Deloitte & Touche has publicly argued that regulators should not prohibit this market choice.¹⁶⁶ As the Deloitte & Touche CEO declared in a *Wall Street Journal* op-ed piece, the SEC proposal is “bad news for corporate decision-makers, since it would restrict public companies’ freedom of choice when seeking outside professional services.”¹⁶⁷ However, many investors and corporations prefer auditors and consultants to come from separate firms. In another *Wall Street Journal* op-ed piece published the same month, the head of a large pension fund declared that it never hires consultants from its auditing firm, and the assurance of auditor independence gives “an enormous benefit” to the fund and its investors.¹⁶⁸ The key policy question is whether market forces or regulation should determine the appropriate balance between auditing independence and consulting synergies.

The SEC’s argument for regulating the accounting industry to ensure the independence of auditors from consultants seems to proceed in this manner. Allowing firms to mix the two groups

164. Tabakoff, *supra* note 158, at 4; see Deloitte & Touche, at <http://www.dttus.com> (last visited Dec. 17, 2001) (on file with the North Carolina Law Review).

165. James Copeland, CEO of Deloitte & Touche, has declared that auditing firms need professionals who:

[P]rovide consultative services in complex areas like information technology, risk management and actuarial science” because “the businesses and systems that auditors test are growing more diversified and complex, and we need expertise to perform the highest quality audits. To attract and retain top specialists, public accounting firms must offer them a chance to work on cutting-edge projects, on a level playing field with other world-class consultancies . . .

James E. Copeland, Jr., Editorial, *Accounting Ain’t Broke, So Don’t Fix It*, WALL ST. J., July 25, 2000, at A22.

166. *Id.*

167. *Id.*

168. See John H. Biggs, Editorial, *Auditors and Consultants Shouldn’t be too Close*, WALL ST. J., July 13, 2000, at A26.

together may taint the quality of audits because consultants have an interest in getting more business from the client and therefore may lean on the accountants to accommodate the client's demands.¹⁶⁹ This potential reduction in audit quality adversely affects the securities markets because third parties, such as investors, rely on the quality of the audit.¹⁷⁰ Government regulation is needed to ensure that securities markets are not harmed.¹⁷¹ Investors cannot rely solely on the decision of the firm's manager about who to hire because they may choose low-quality auditors.¹⁷² True, the choice of low-quality auditors will harm the firm's stock price if investors shun its stock, and thus the firm itself has an incentive to hire high-quality auditors. But if investors cannot differentiate between firms that hire good and bad auditors, bad information enters the marketplace.¹⁷³ This will create a lemons problem that hurts the price of all stocks.¹⁷⁴ In other words, if markets are imperfect, and investors do not distinguish between high and low-quality auditors, then the SEC must require audit firms to be separate from consultants to ensure that all firms are not penalized for some firms' decisions to hire low quality auditors.

Acting on its theory, in November 2000 the SEC changed its auditor independence regulations,¹⁷⁵ adopting a two-pronged

169. Irving Faught, *Auditor Independence Builds Confidence*, DAILY OKLAHOMAN (Oklahoma City, Okla.), Nov. 30, 2000, at 3C (asserting that government regulation minimizes improper influence and promotes investor confidence); see also *Spoilt For Choice*, *supra* note 162, at 65 (discussing accounting problems at Waste Management that may have resulted from a conflict of interest). In fact, the first study to examine this question using data that was disclosed under the new SEC rules confirms that the provision of non-audit services impairs auditor independence and reduces the quality of company earnings. Richard M. Frankel et al., *Auditor Independence and Earnings Quality* (research paper, Stanford University Graduate School of Business) (2001).

170. Faught, *supra* note 169.

171. See *id.* (asserting that government regulation minimizes improper influence and promotes investor confidence).

172. Michael Mulligan, *New Rules on Auditor-Client Relationships*, NAT'L L.J., Jan. 15, 2001, at B13 (noting that accountants do not follow their own professional standards, which has forced the SEC to adopt new auditor independence rules of its own).

173. See *Testimony of Federal Reserve Officials*, 86 FED. RES. BULL. No. 11, at 735 (Nov. 21, 2000) (testimony of Laurence H. Meyer).

174. J. Edward Ketz & Paul B.W. Miller, *The De-myth-tification of Accounting and Auditing*, ACCT. TODAY, Apr. 3, 2000, at 14-15.

175. The proposed rules appear at 65 Fed. Reg. 43,148 (July 12, 2000) (codified at 17 C.F.R. § 210.2-10). A discussion of the final rules appears in Revision of the Commission's Auditor Independence Requirements, Exchange Act Release No. 33-7919, [2000-2001 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,406, at 83,989 (Nov. 21, 2000), available at <http://www.sec.gov/rules/final/33-7919.htm> [hereinafter Revised Independent Auditor Requirements]. For an in-depth discussion of the new rules, see generally William R. McLucas & Paul R. Eckert, *The Securities and Exchange Commission's Revised Auditor Independence Rules*, 56 BUS. LAW. 877 (2001).

approach to auditor independence.¹⁷⁶ First, the SEC created a general standard of independence that asks whether a fully informed “reasonable investor” would conclude the accountant is capable of independent judgment on all issues.¹⁷⁷ Second, the SEC enumerated a non-exclusive list of specific situations in which auditor independence is inherently corrupted.¹⁷⁸ Of particular relevance is the SEC’s declaration that an accountant is not independent if, during an audit period, the accountant provides information-technology or other consulting services,¹⁷⁹ or legal services,¹⁸⁰ to the audit client.

The new SEC regulations may be less invasive than accounting firms had feared. They do not completely ban firms from providing consulting services to their audit clients. Rather, they take a self-avowedly “pragmatic approach” by requiring only that companies disclose the fees paid to their auditor for consulting services¹⁸¹ and setting forth five procedural conditions for mixing, auditing, and consulting.¹⁸² These disclosures have shown that the non-audit fees

176. Revised Independent Auditor Requirements, *supra* note 175, at 84,010.

177. 17 C.F.R. § 210.2-01(b) states the test as whether “a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not capable of exercising objective and impartial judgment on all issues encompassed within the accountant’s engagement.” See Joanne Rockness et al., *Auditor Independence: A Bit More Rope*, FIN. EXECUTIVE, Jan. 1, 2001, at 18, 19–22.

178. See 17 C.F.R. § 210.2-01(c)(1)–(5) (2001); Revised Independent Auditor Requirements, *supra* note 175, at 83,991.

179. See 17 C.F.R. § 210.2-01(c)(4)(i)–(viii) (2001) (restricting accountants from engaging in bookkeeping, financial information systems design and implementation, appraisal or valuation services or fairness opinions, actuarial services, internal audit services, management functions, human resources, or broker-dealer services).

180. See 17 C.F.R. § 210.2-01(c)(4)(ix) (2001) (prohibiting accountants from engaging in legal services).

181. The SEC articulated its self-avowed leniency regarding this restriction in its final ruling on the matter:

The rule also takes a pragmatic approach to the potential independence problem posed by the economic incentives that accompany large consulting contracts. Rather than effectively ban those relationships, we are amending the proxy disclosure rules to require public companies to make specific disclosure of fees paid to their auditor for information technology services.

Revised Independent Auditor Requirements, *supra* note 175, at 84,059–60.

182. 17 C.F.R. § 210.2-01(c)(4)(ii)(B)(1)–(5) (2001). First, “[t]he audit client’s management has acknowledged in writing to the accounting firm and the audit client’s audit committee . . . the audit client’s responsibility to establish and maintain a system of internal accounting controls.” *Id.* Second, the audit client’s management must designate an employee in senior management “to make all the management decisions with respect to the design and implementation.” *Id.* The third condition clarifies the types of “management decisions” the particular employee will be required to make. *Id.* The last two conditions require the audit client to make an independent evaluation of “the adequacy and results of the design and implementation of the hardware or software system.” *Id.*

paid by Standard & Poor's (S&P) 500 company clients to Big Five firms dwarf the size of the audit fee. A Wall Street Journal study of 307 S&P 500 companies which had made these disclosures found that "the fees for [nonaudit] services were nearly three times as big as the audit fees. Specifically, those companies paid a combined \$909 million [in 2000] for auditing services, compared with \$2.65 billion for other services, including \$554 million for information-technology services."¹⁸³

What light can our model shed on these upheavals in accounting? Foremost, these firms' split-ups illustrate how high internal organization costs can be as firms grow to handle large projects. These costs are particularly high when one specialty (here, consulting) consistently out-performs another (here, auditing). The consultants feel they are subsidizing the auditors, while the auditors feel under-appreciated. Even if clients value one-stop shopping, syndication may be a more efficient way to provide services in this situation. As we saw earlier, the consolidators (who are legally prohibited from combining consulting and auditing in a single firm) have found it worthwhile to offer auditing and consulting through syndicate arrangements. The Big Five firms, coming from the other direction of unified operations, are also opting for more syndicated arrangements.

While some commentators have suggested that the recent spin-offs of the Big Five are driven by the new regulatory threats,¹⁸⁴ economic forces may be equally crucial. The extra ability to service huge clients in a single operation may not be worth the internal costs, given the viability of looser syndicate arrangements. One of the costs comes from the legal restrictions on auditing ownership.¹⁸⁵ Consultants freed of these restrictions can tap public capital markets to raise cash. As our model suggests, firms must balance the agency costs of internal growth with the transaction costs of syndication. In the case of auditing and consulting, time will tell if syndication will

183. Jonathan Weil & Jeffrey Tannenbaum, *Big Companies Pay Audit Firms More for Other Services*, WALL ST. J., Apr. 10, 2001, at C1; see also Jonathan Weil, *New Disclosure Rules Became Issue for Raytheon*, WALL ST. J., May 3, 2001, at C1 (discussing how Raytheon restated its financial results for three years, and that plaintiffs' lawyers are concerned that the company paid its auditors, PricewaterhouseCoopers, three-million dollars in audit fees and forty-eight million dollars for other services).

184. See Ken Brown & Mary Morrison, *War of the Andersens Draws to a Close As Arbitrator Submits Ruling to Court*, WALL ST. J., July 14, 2000, at C1 ("[S]ome of Arthur Andersen's big rivals have dumped or are exiting their consulting businesses to satisfy the regulators.").

185. See 17 C.F.R. § 210.2-01(c)(1).

prove to be the more efficient option if SEC regulations are not prohibitive.

D. *Multidisciplinary Practice of Accounting and Law*

In sharp contrast to their efforts to shed their consulting divisions, the Big Five have been moving full bore into the legal industry. Clients of these firms have been clamoring for them to offer a full range of legal services.¹⁸⁶ The biggest accounting firms want to transform themselves into integrated professional service providers, commonly referred to as Multidisciplinary Practice firms (MDPs).¹⁸⁷

These firms have been building up their internal legal groups in recent years, aggressively recruiting partners from law firms and hiring students straight out of law school.¹⁸⁸ Arthur Andersen currently employs over 3,500 lawyers, more than any law firm in the world.¹⁸⁹ Its legal unit, Andersen Legal, saw its revenues increase by over thirty percent in 1999, reaching \$482 million for the fiscal year.¹⁹⁰ PricewaterhouseCoopers currently employs over 1,600 lawyers in forty-two different countries in its Landwell unit.¹⁹¹ It has declared its intention to become one of the world's five largest law firms within the next five years.¹⁹² The other Big Five firms also have large

186. Margaret A. Jacobs, *Accounting Firms Covet Forbidden Fruit: Piece of U.S. Legal Market*, WALL ST. J., May 31, 2000, at B1; Fischel, *supra* note 63, at 960 (stating that general counsels of major corporations and commercial entities are the clients most actively demanding changes to current rules).

187. David Jackson, *Corporate Legal Services—Customers Set to Benefit as SA Will Follow the Worldwide Trend Towards MDPs*, BUS. DAY (South Africa), May 8, 1999, at 24 (“The worldwide trend toward multidisciplinary practices (MDPs) is boosting competition in what has been the separate domains of the legal and accounting professions. Driving this move is the globalization of business and the emergence of international accounting firms as players in the market for specialist services.”); Paul Merrion, *Auditors at Law: Attorneys Fret as CPAs Encroach on Their Turf*, CRAIN’S CHI. BUS., Jan. 17, 2000, at 15.

188. REPORT TO THE HOUSE OF DELEGATES, *supra* note 97, at 15 (noting the Big Five’s success in recruiting “tax partners from leading law firms and prominent government lawyers to join the Big Five, and in persuading law students to join their staffs directly after graduation rather than following the more traditional law-firm career path”); UPDATED BACKGROUND REPORT *supra* note 102, at 2; Fischel, *supra* note 63, at 952.

189. Jacobs, *supra* note 186.

190. REPORT TO THE HOUSE OF DELEGATES, *supra* note 97, at 16 n.50. This was more than double that of the average American Lawyer Top 100 law firm.

191. REPORT TO THE HOUSE OF DELEGATES, *supra* note 97, at 17.

192. See Roger Trapp, *Big Five Take the Law Into Their Own Hands*, THE INDEPENDENT (London), May 31, 2000, at 6, available at 2000 WL 17611161 (“Already claiming to be the world’s fourth-largest legal practice, with 1,450 lawyers, excluding tax specialists, [PricewaterhouseCoopers] has a vision to be in the top five global providers of legal services by reputation rather than size by 2004.”).

numbers of lawyers working for them.¹⁹³ Indeed, as table 7 shows, each Big Five firm is among the top-thirty international law firms. While this growth continues unabated, substantial barriers to the creation of MDPs in most countries remain.

Historically, accounting firms have been forbidden to offer legal services.¹⁹⁴ The most that law firms and accounting firms could do was refer clients to one another. When clients had matters that required both accounting and legal services, firms from both areas would work together to handle these jobs. But they could not share profits because of legal prohibitions against such activity. These arrangements were informal and could change between jobs.

Over the past decade, clients have started to demand integrated legal and accounting services from one company.¹⁹⁵ Increases in the number of international mergers and acquisitions and other complex business transactions have led clients to seek out more efficient ways of obtaining professional services.¹⁹⁶ The demand for MDPs is driven by the clients' sense that these arrangements would be a more efficient, less costly way for them to deal with complex matters that have legal, accounting, and management issues.¹⁹⁷ Clients' demands have shifted the probability distribution for future jobs, leading the Big Five to build up their internal legal groups.

This process began in the tax area. Accountants are heavily involved in the tax planning of most major businesses. These matters have significant legal aspects to them, which accounting firms had

193. UPDATED BACKGROUND REPORT, *supra* note 102, at 6 (summarizing the American Lawyer's November 1998 report stating that KPMG employed 988 lawyers, Ernst & Young had 851 attorneys, and Deloitte & Touche had 586 attorneys world-wide).

194. See MODEL RULES OF PROF'L CONDUCT R. 5.4 (2001); text accompanying note 210.

195. REPORT TO THE HOUSE OF DELEGATES, *supra* note 97, at 12–13 (“The Commission is firmly convinced that there is substantial evidence of client interest in expanding the universe of legal service providers to include MDPs.”); Bartel, *supra* note 35, at 5 (asserting that multinational firms like one-stop shopping because they can reduce the number of law firms that they are dealing with, thereby getting better management of their legal matters, lowering their legal fees and overhead, and assuring better quality). The ABA report also noted that the American Corporate Counsel Association is urging the elimination of legal barriers to the establishment of MDPs. *Id.* at 14.

196. Fischel, *supra* note 63, at 970.

197. REPORT TO THE HOUSE OF DELEGATES, *supra* note 97, at 13 (noting the need for multidisciplinary counseling for clients in some matters and that it is inefficient to try to satisfy that need with coordinated advice from professionals in unrelated firms); Dzienkowski & Peroni, *supra* note 34, at 118–24; Fischel, *supra* note 63, at 963 (“MDPs are premised on the assumption that different service providers within a single firm can share information about clients' needs and coordinate possible strategies more efficiently than if the same services are purchased from multiple firms.”); Breakley, *supra* note 34, at 276.

traditionally farmed out to law firms to avoid claims that they were engaged in the unauthorized practice of law. Over time, the accounting firms realized that this legal prohibition had few teeth: most of their tax clients' legal issues could be handled by their own in-house lawyers. So long as the in-house lawyers avoided appearing in court to handle litigation (something that few tax lawyers do), technically they do not practice law.¹⁹⁸ The firms started aggressively hiring tax partners from major law firms. Clients began to routinely have their accounting firms handle all of their tax matters, except for litigation.

Today, all of the Big Five firms offer these services and their legal groups have prospered. These professional service firms aggressively solicit clients, seeking to provide the same services that traditional law firms have supplied.¹⁹⁹ Their legal services groups have expanded rapidly with the benefit of cross-selling by their accounting/consulting partners. They have also benefited because they can deliver legal services efficiently using the sophisticated technologies that they developed to service their accounting and consulting clients.²⁰⁰

The legal-accounting affiliations are most developed in Europe, where the legal prohibitions against MDPs have come under pressure to acknowledge modern realities. Switzerland allows fully integrated MDPs.²⁰¹ Many other foreign countries are considering permitting full-blown MDPs, with England leading the way with proposed legislation legalizing the creation of these entities.²⁰² In the interim, the Big Five have engaged in intermediate contractual arrangements with English law firms, including cross-identification on letterhead and advertising, cross-referral of clients, and purchasing of consulting

198. See Jacobs, *supra* note 186 ("The major accounting firms have long employed in-house attorneys who offer advice on taxes and certain other topics but who technically don't practice law.").

199. COMMISSION ON MULTIDISCIPLINARY PRACTICE, BACKGROUND PAPER ON MULTIDISCIPLINARY PRACTICE: ISSUES AND DEVELOPMENTS (Jan. 1999), at 3 [hereinafter MDP BACKGROUND PAPER].

200. Joseph L. Kashi, *Technology and Economics Are Changing How You Practice Law*, 20 L. PRAC. MGMT. 44, 46 (1994); Pruner, *supra* note 69.

201. Commission on Multidisciplinary Practice, Appendix C, Reporter's Notes [hereinafter MDP Reporter's Notes], at 27 n.11 (stating that ATAG Ernst & Young is the biggest law firm in Switzerland).

202. REPORT TO THE HOUSE OF DELEGATES, *supra* note 97, at 17 (summarizing some of the regulatory responses that various countries have taken or are currently considering that would affect MDPs); UPDATED BACKGROUND REPORT, *supra* note 102, at 3-4 (detailing various foreign countries' bar associations' actions concerning MDPs).

and supplies.²⁰³

These new affiliates provide legal services directly to clients, even for complex mergers and acquisitions and corporate finance issues.²⁰⁴ At PricewaterhouseCoopers in Paris, for instance, the law firm is owned by the attorneys, but they also “share the same client base as the accounting firm, work very closely with it, and benefit from volume cost savings within the PricewaterhouseCoopers network that result from leasing space in the same office building as the accounting firm, bulk buying, [and] the common use of telephone and computer systems.”²⁰⁵ While most of their clients are small at present, the Big Five have publicly stated that they intend to compete directly with the major international law firms.²⁰⁶

The European experience fits well within the framework of our model. Given the choice between internal expansion and syndication, the Big Five would rather create MDPs by internally expanding to meet the shift in current (and predicted future) client demand for integrated professional service firms. Since legal restrictions currently limit the availability of this option, these firms have created syndicates with captive law firms to get around the legal rules.²⁰⁷ Simultaneously, these firms and their clients are pushing to have the legal rules changed to permit the formation of MDPs.²⁰⁸

We would predict that as the rules change, and MDPs become feasible in many countries, many firms will rush to meet clients' demands for integrated services. The Big Five will have a significant head start, but large international law firms, consulting firms, and consolidators will quickly try to catch up through mergers and

203. The Big Five have limited their activities to:

[C]ontractual arrangements with law firms, whereby (1) the law firm agrees to identify its affiliation with the professional services firm on its letterhead and business cards, and in its advertising . . . ; (2) the law firm and the professional services firm agree to refer clients to each other on a nonexclusive basis; and (3) the law firm agrees to purchase goods and services from the professional services firm such as staff management, communications technology, and rent for the leasing of office space and equipment. The law firm remains an independent entity controlled and managed by lawyers and accepts clients who have no connection with the professional services firm.

MDP Reporter's Notes, *supra* note 201, at 27. These arrangements would run afoul of the legal restrictions in the U.S.

204. Jacobs, *supra* note 186.

205. MDP BACKGROUND PAPER, *supra* note 199, at 5.

206. Jacobs, *supra* note 186.

207. MDP Reporter's Notes, *supra* note 201, at 4 n.12 (listing testimony of various witnesses concerning captive law firm arrangements).

208. *Id.* (listing testimony of various accounting firm representatives and changes in European country restrictions that resulted).

acquisitions. A wave of aggregation should sweep across European firms in different nations as those countries drop their barriers to MDPs.

In the United States, legal rules currently prevent firms from creating MDPs.²⁰⁹ The prohibitions come from both the law and accounting regulations. On the legal side, Rule 5.4 of the Model Rules of Professional Conduct prohibits lawyers from forming partnerships with non-lawyers if any of the activities of the partnership constitutes the practice of law.²¹⁰ On the accounting side, the new SEC regulations find a breach of auditor independence if the auditing firm provides any service to an audit client that requires an attorney “admitted to practice” before a U.S. court.²¹¹ The SEC echoes the view of the ABA’s Commission on Multidisciplinary Practice, stating that “[we] explicitly recognize[] the incompatibility [of legal and audit services]. [We] do not believe that a single entity should be allowed to provide legal and audit services to the same client.”²¹² Despite the strong rhetoric, the SEC regulations continue to permit Big Five firms to offer lawyers to their clients so long as the lawyers are not practicing law before a U.S. court. This “loophole” will allow the Big Five firms to continue expanding their legal departments, even in the United States,²¹³ although full-blown MDPs are not yet permitted.

Just as in Europe, the American experience is that syndicate-like arrangements arise when accounting firms are legally barred from providing full legal services. These arrangements, while perhaps not as economically efficient as the internal expansion of the Big Five in Europe, are a second-best way of trying to satisfy client demand in the United States.

The most provocative of these arrangements is the creation of the law firm of McKee Nelson Ernst & Young (now McKee Nelson,

209. See Fischel, *supra* note 63, at 951–52 (detailing various rules which prohibit or restrict the emergence of MDPs).

210. *Id.*

211. See Regulation S-X, Qualifications of Accountants, 17 C.F.R. § 210.2-01(c)(4)(ix) (2001) (stating there is a breach of auditor independence by “[p]roviding any service to an audit client under circumstances in which the person providing the service must be admitted to practice before the courts of a United States jurisdiction”).

212. Revised Independent Auditor Requirements, *supra* note 175, at 83,995 (quoting the REPORT TO HOUSE OF DELEGATES, *supra* note 97).

213. See Nathan Koppel, *A Regulator Budes (and Fudges) on MDPs*, AM. LAW., Jan. 2001, at 20 (concluding that SEC regulations will allow Big 5 to expand their legal services); Geanne Rosenberg, *SEC’s New Rules Will Likely Allow Big Five to Expand Legal Services*, NAT’L L.J., Dec. 4, 2000, at B7 (predicting that legal branches of the Big Five will probably expand or at least maintain the status quo).

LLP) in Washington, D.C. in November 1999.²¹⁴ Five partners of the King & Spalding law firm left to create their own law firm but with a very unusual financial relationship with the accounting firm Ernst & Young. The law firm agreed to include the Ernst & Young name as part of its name in exchange for a “significant amount of start up capital” and a lease in Ernst & Young’s building.²¹⁵ This represents a major step by one of the Big Five accounting firms in the direction of MDPs.²¹⁶

Other Big Five firms have entered into strategic alliances with American law firms over the past few years. PricewaterhouseCoopers (PwC) entered into an agreement with a tax specialty firm, Miller & Chevalier, in 1997. Miller & Chevalier will provide litigation services for PwC’s clients that need to fight “high stakes, complex tax controversies in the United States.”²¹⁷ In 1999, KPMG, another Big Five firm, announced a strategic alliance with law firms that belong to Saltnet, a network of tax lawyers.²¹⁸ This group includes well-known law firms Morrison & Foerster and Horwood Marcus & Berk.

Despite the growth of hybrid arrangements, pressure is growing on U.S. legal regulators to abandon the existing restrictions on MDPs. Critics argue the current system is an anticompetitive barrier erected by an interest group, the organized bar, to protect its turf,²¹⁹ and results in higher prices and fewer services for clients.²²⁰ If clients go to the organization that can most effectively solve their problems, then

214. REPORT TO THE HOUSE OF DELEGATES, *supra* note 97, at 14.

215. *Id.*

216. *Id.*; UPDATED BACKGROUND REPORT, *supra* note 102, at 2–3 nn.9–10.

217. REPORT TO THE HOUSE OF DELEGATES, *supra* note 97, at 15; UPDATED BACKGROUND REPORT, *supra* note 102, at 2 n.6.

218. REPORT TO THE HOUSE OF DELEGATES, *supra* note 97, at 15; UPDATED BACKGROUND REPORT, *supra* note 102, at 2 n.8.

219. See Fischel, *supra* note 63, at 953–54, 969–74; Jacobs, *supra* note 89, at 6; Tunku Varadarajan, *Why is the ABA Afraid of a Little Competition for Lawyers?*, WALL ST. J., July 24, 2000, at A27 (declaring that the ABA voted against multidisciplinary practice to protect its own economic position).

220. See Cindy Krischer Goodman, *One Firm Fits All*, MIAMI HERALD, Mar. 14, 1999, at 1E (stating that proponents say that current rules result in higher prices and fewer services for clients). The American Corporate Counsel Association has endorsed the move to permit the formation of MDPs. Many small firms are also interested in permitting these entities to be created. REPORT TO THE HOUSE OF DELEGATES, *supra* note 97, at 14; see also John S. Dzienkowski & Robert J. Peroni, *Multidisciplinary Practice and the American Legal Profession: A Market Approach to Regulating the Delivery of Legal Services in the Twenty-First Century*, 69 FORDHAM L. REV. 83, 117 (2000) (noting generally that a more competitive market for professional services should translate into lower prices).

lawyers risk being replaced if they fail to adapt to the new competitive landscape.²²¹ Traditional American law firms are at a serious competitive disadvantage, the critics continue, compared to other service providers that are better financed, have newer technologies, and offer better cross-professional services.²²² Perhaps facing this reality, the ABA's Commission on Multidisciplinary Practice initially recommended that the ABA House of Delegates approve some limited changes to the current prohibitions, only to see its proposals rejected by the full membership.²²³

Defenders of the current system more or less concede that individual clients may prefer MDPs on efficiency grounds,²²⁴ although they suggest that supporters exaggerate current client demand for MDPs.²²⁵ Rather, defenders argue that MDPs will severely damage the legal profession's "core values" of independence, confidentiality, and self-regulation.²²⁶ Attorneys must "exercise independent judgment and render candid advice,"²²⁷ but will be reluctant to do so if the candid advice upsets the client who not only chooses another lawyer for future work, but removes the accounting and consulting business from the MDP as well.²²⁸ MDPs risk client confidentiality as well. Lawyers in a MDP cannot ensure confidentiality because the duty of the auditor (who is now a fellow employee or partner of the MDP lawyer) to disclose adverse information will overrule the attorney-client privilege.²²⁹ Another danger of MDPs, say defenders of the ban, is that lawyers may lose their privilege of regulating themselves if they are seen as "just another set of service providers in a department store."²³⁰

As with the SEC's proposed separation of auditing and consulting services, we need to look critically at the arguments that the current rules against MDPs address a market failure. The

221. Pruner, *supra* note 69, at 90–91.

222. *Id.*

223. See Varadarajan, *supra* note 219, at A27 (declaring that "[b]y voting against change, the ABA's delegates confirmed yet again that their instincts are protectionist and that they subscribe not so much to a free market system as to a guild system").

224. See Lawrence J. Fox, *Dan's World: A Free Enterprise Dream; An Ethics Nightmare*, 55 BUS. LAW. 1533, 1533 (2000).

225. See Dzienkowski & Peroni, *supra* note 34, at 135 (observing that "[o]pponents are convinced that the demand for integrated professional services is largely manufactured by the excellent marketing efforts of the Big Five accounting firms").

226. *Id.* at 137.

227. Fox, *supra* note 224, at 1540.

228. *Id.* at 1542.

229. *Id.* at 1555.

230. *Id.* at 1551.

conclusion that regulation is needed rests on the following claims: Lawyers are licensed officers of the court, who are professionally inculcated with ethical duties that include zealous representation of clients within the bounds of the law. In other words, lawyers worry about misleading courts and agencies, and will not do just anything to further their client's interests. Society benefits from these ethical limitations on lawyers' activities.

The second step in the argument is more difficult. Working in firms with other professionals, such as accountants or consultants, will taint the independence of lawyers. While many clients may choose to hire only attorneys that do not suffer from such conflicts, some clients will not. MDPs will be more willing to serve the selfish interests of the client because of their greater financial interests in selling a bigger bundle of services to the client.²³¹ This will lead to more unethical behavior by lawyers which is bad for society because it leads to inaccurate results by courts and agencies.

This argument is more problematic than the analogous one advanced for auditors. For one thing, a stronger claim of third party reliance exists for accountant certifications than for legal advice. Much of the federal securities laws are built on the premise that accountants act as neutral arbiters of generally accepted accounting practices and other norms, and that investors are entitled to rely on accountants' opinions in making their investment decisions. By contrast, lawyers do not have a central role under the federal securities laws, and there is less reason for investors to heed their public pronouncements. Second, lawyers act as advocates and advisors of what is in their client's best interests. Third parties are aware of this fact, and therefore discount lawyers' public statements accordingly.

Although we recognize that concerns about attorney independence remain a major stumbling block to the creation of MDPs, we predict that these regulatory prohibitions will be eliminated because they do not permit firms to adjust their size and composition to respond to new probability distribution of jobs. As the shift in client demand becomes increasingly clear to all of the firms affected, and the Big Five's inroads into traditional legal fields continue to widen, law firms will join the bandwagon of those in favor

231. Cf. Robert A. Prentice, *The SEC and the MDP: Implications of the Self-Serving Bias for Independent Auditing*, 61 OHIO ST. L.J. 1597, 1597-1602 (2000) (making a similar argument about auditors in a MDP).

of change.²³²

As we have documented, however, American law and accounting firms are already using various forms of syndication to provide joint services. While less efficient than a fully integrated MDP might be, many of the perceived costs of MDPs already exist. As these syndicate arrangements are increasingly used to avoid ethical restrictions, one wonders whether the independent judgment and the confidentiality of the lawyers is already compromised. If so, we might have the worst of both worlds—substantially compromised lawyers and accountants without the full efficiency gains. It might be better to let clients choose. Those who are willing to pay for strict separation of their accountants and lawyers can always get that separation, and whatever benefits from independent judgment or confidentiality that come with it. But we do not see how other clients, who prefer the lower price or higher quality that comes from fully integrated accountants and lawyers in an MDP, are harming others or “the market” in general. In the absence of such third-party effects, the case for regulation is weak. Increased pressure will be brought on the ABA to drop the prohibition on MDPs.²³³

If the legal restrictions in the United States crumble, there will be a rush to create integrated MDPs. Permutations of law firms, accounting firms, money managers, and consultants will form unions of various types to try to offer professional services to clients. Many clients may choose to use separate firms for each of these services, at least until they are confident that the new entities can provide the appropriate quality of services without complications.

Over time, a new equilibrium will develop with MDPs as only one of the players, perhaps the dominant ones, in the market place. The structure of the new equilibrium will depend on the same variables that we have focused on throughout this paper: internal organization costs, syndication costs, the probability distribution of jobs, the size and structure of other firms, and legal rules. As we saw in our discussion of the break-up of consulting and accounting firms, increasing internal organization costs can lead to the conclusion that bigger is not always better.

232. See Fischel, *supra* note 63, at 971 (claiming that tax lawyers and large law firms are most likely to argue in favor of repeal of current prohibitions against MDPs).

233. *Cf. id.* at 974 (arguing that current rules will lose support as interest group support for them wanes).

IV. THE RISE AND FALL OF SYNDICATION IN INVESTMENT BANKING

The securities underwriting industry provides another good application for our model. Syndication is a widely used and efficient form of organization for investment banks that are distributing newly issued securities.²³⁴ In a typical securities underwriting, a group of investment banks join together under a lead underwriter to market an issue of stock or bonds to their clients.

When securities underwriting first appeared, issuing companies did not use syndicates in the distribution of financial securities on behalf of issuing companies.²³⁵ Only later when clients demanded that investment banks raise larger sums did syndicates become popular.²³⁶ As we explain below, in recent years, investment banks have grown to take advantage of the shift in the probability distribution of jobs toward bigger offerings, causing syndicate usage to decline. A second factor contributing to the decline in syndicate size is the adoption of Rule 415, the shelf registration rule,²³⁷ and the resultant increase in the relative costs of syndication.

As with law firms, our model emphasizes the demand side as a critical explanation for the size and structure of investment banks. Shifts in the probability distribution of jobs alter the relative costs of syndication versus internal growth, and can spur internal growth. Other researchers have focused on the role of syndication as insurance against financial risk, a “supply-side” explanation of industry structure.²³⁸ While these theories are useful, they are incomplete. Our model provides additional insights into why firms

234. As one court put it:

This evolution of the syndicate system was in no sense a plan or scheme invented by anyone. Its form and development were due entirely to the economic conditions in the midst of which investment bankers functioned. No single underwriter could have borne alone the underwriting risk involved in the purchase and sale of a large security issue. *No single underwriter could have effected a successful public distribution of the issue.*

United States v. Morgan, 118 F. Supp. 621, 640 (S.D.N.Y. 1953) (emphasis added).

235. See *infra* notes 240–41 and accompanying text.

236. See *infra* notes 242–48 and accompanying text.

237. Delayed or Continuous Offering and Sale of Securities, 17 C.F.R. § 230.415 (2001).

238. The idea of risk sharing has led to formal analyses of decision-making within a syndicate. See, e.g., Amin H. Amershi & Jan H.W. Stoeckenius, *The Theory of Syndicates and Linear Sharing Rules*, 51 *ECONOMETRICA* 1407 (1983); Robert Wilson, *The Theory of Syndicates*, 36 *ECONOMETRICA* 119 (1968).

syndicate securities distributions.²³⁹

Prior to 1870, the marketing of an issuer's securities to investors was handled by a single firm. A single investment bank would enter into a contract with the issuer for the purchase of the entire issue at a particular price.²⁴⁰ The issuer received a fixed sum and shifted the risks of the market to the investment banker, what today we would call a firm-commitment underwriting. Subsequently, the investment banker would attempt to sell the securities at an increased price to its individual pool of investors.²⁴¹

Investment banks were small in comparison with today. In the past, we postulate that they must have had relatively low internal organization costs because of their smaller scale and narrower scope than the firms that dominate the market now. The demand for future services by clients was for banks to raise fairly small amounts of capital, making syndication unnecessary.

As businesses grew, their capital needs expanded and the size of securities offerings dramatically increased. It became increasingly difficult for a single investment banker to underwrite a given issue of securities. Beginning around 1870, numerous underwriters were required for a single deal, leading firms to develop the syndication process.²⁴² By combining forces, the investment banks could market the larger securities issues needed to meet the increasing demand for capital.²⁴³

239. A variety of other factors have also contributed to the recent concentration in the underwriting business, such as, the repeal of the Glass-Steagall Act, the end of fixed commission rates for the brokerage business, the globalization of securities markets, and the Internet's effects on investment banking. See JAMES D. COX ET AL., *SECURITIES REGULATION* 217-19 (3d ed. 2001) for further discussion of these factors. Again, our point is that a demand-side analysis provides a complementary explanation for the increased size of firms in this area.

240. In the late 1800s, most businesses were small, privately owned manufacturers and merchants with small capital needs. With the industrial growth of the early 1900s, these firms needed to raise capital from individual and institutional investors to supply growing businesses. KENNETH J. BIALKIN & WILLIAM J. GRANT, JR., *SECURITIES UNDERWRITING: A PRACTITIONER'S GUIDE* 4-6 (1985).

241. LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* § 2A.2 (3d ed. 1995).

242. "Jay Cooke is credited with having introduced the "underwriting syndicate" into this country in the sale of a two million bond issue by the Pennsylvania Railroad in 1870." LOUIS LOSS, *SECURITIES REGULATION* 164 (2d ed. 1961).

243. In addition, the syndication process placed less financial liability on each individual investment bank. An effective syndicate will spread risk amongst investment banks and contain prestigious bankers to insure market acceptance. It also ensures distribution of shares to the appropriate type of investor. For instance, placing stock with numerous smaller investors tends to create a more stable aftermarket for the issue. PHILIP W. TAGGART & ROY ALEXANDER, *TAKING YOUR COMPANY PUBLIC* 90-93 (1991).

Syndication enabled bankers to bring an issuer's securities to market without having to incur the higher internal organization costs that would arise if individual firms expanded. Syndication, while costly, allowed firms to conserve on these expenses.²⁴⁴ However, the creation of a large syndicate greatly reduced the revenues earned by any individual investment bank for a single underwriting because they had to share the fees with other syndicate members.

In our model's terminology, the probability distribution for underwriting jobs shifted toward the issuance of larger blocks of securities toward the turn of the century. However, this did not lead firms to expand to a large enough size to handle their clients' underwriting needs by themselves, but rather to engage in syndication. Although we lack data to test our theory, we hypothesize that this shift occurred because syndicates were at that time a relatively more efficient method of handling these bigger jobs.

During the 1990s, the largest firms have grown considerably, both through internal expansion and by mergers and acquisitions. Table 8 compares the annual sales and number of employees for eight large investment banks in the early and late 1990s. In all cases, the firms' annual sales and number of employees have increased significantly.

Integrated financial service giants are rapidly emerging. Driven by the need for greater scope and more capital, many of the smaller, pure play investment banks have merged with commercial banks over the past year.²⁴⁵ Independent investment banks like J.P. Morgan and PaineWebber have been acquired by banks seeking to offer their corporate clients all services—debt, underwriting, mergers and acquisitions advice, and corporate lending.²⁴⁶ Every firm needs to offer clients one-stop shopping, or be frozen out of big underwriting deals.²⁴⁷

244. Syndication also permitted firms to shift losses across a broader group of firms. If losses occurred during the existence of the syndicate due to pricing, shifts in interest rates, or other factors, the syndicate bore them. In a large syndicate, these losses were distributed so that no individual investment bank would be harmed too badly. BIALKIN & GRANT, *supra* note 240, at 277.

245. Smith & Gasparino, *supra* note 29.

246. Steve Lipin et al., *Blending Legends*, WALL ST. J., Sept. 13, 2000, at A1. Similar trends can be seen among independent mergers and acquisitions advisory firms. For example, Wasserstein Perella merged with Dresdner Bank. Erik Portanger & Randall Smith, *Dresdner Bank in Talks to Buy Wasserstein Perella*, WALL ST. J., Sept. 12, 2000, at C1.

247. Lipin, *supra* note 72 (noting that J.P. Morgan had this problem in competing for large underwriting deals).

TABLE 8: Growth of Major Investment Banks in the 1990s

Name of Bank	Date	Annual Sales (millions of dollars)	Number of Employees
A.G. Edwards	1990	\$607	6,694
	1998	2,004	12,967
Bear Stearns	1990	2,386	5,732
	1998	7,980	9,200
Goldman Sachs	1993	14,848	8,103
	1997	20,433	11,000
J.P. Morgan	1990	N/A	12,968
	1997	17,701	16,943
Lehman Brothers	1990	8,750	N/A
	1997	16,883	8,340
Merrill Lynch	1990	11,213	39,000
	1997	31,731	56,600
Morgan Stanley Dean Witter	1990	4,506	N/A
	1997	27,132	47,277
PaineWebber	1990	2,978	12,700
	1997	6,657	16,600

Source: HOOVER'S HANDBOOK OF AMERICAN BUSINESS (1999)

This point is well illustrated by the recent IPO of Agere Systems Inc. Lucent Technologies, which had been beset by financial problems, decided to spin off Agere Systems Inc. through an IPO, and assembled a strong team of underwriting firms to manage the sale.²⁴⁸ The price for participation in the underwriting syndicate, though, was steep: only firms willing to lend the company between \$100 million and \$1 billion dollars were offered manager or co-manager roles.²⁴⁹ Traditional investment banking firms, such as Goldman Sachs and others, were unwilling to put their balance sheets at risk to this degree.²⁵⁰ By contrast, commercial banks with investment banking subsidiaries welcomed the opportunity to use their lending operations, which are low-margin operations, to displace other competitors and capture some of the high margin underwriting

248. Suzanne McGee, *Lucent Rewarded Lenders with Underwriter Roles*, WALL ST. J., Feb. 28, 2001, at C1.

249. *Id.* Among the commercial bank-owned investment banks underwriting the deal were Citigroup/Salomon Smith Barney, J.P. Morgan Chase, and D.B. Alex Brown. *Id.*

250. Randall Smith & Suzanne McGee, *Bank's Lending Clout Stings Securities Firms*, WALL ST. J., June 15, 2001, at C1. Traditional investment banking firms, such as Goldman Sachs Group and Merrill Lynch & Co., have been unable to participate in large, recent IPO's because they will not offer low-interest loans to issuers. *Id.* By contrast, commercial banks that are willing to make these loans to firms have garnered the lion's share of those company's underwriting business. Commercial banks claim they are offering clients "one-stop shopping." *Id.*

business.²⁵¹ One-stop shopping is a powerful force shaping the future of the underwriting business.

At the same time, the size of underwriting syndicates has dramatically declined.²⁵² The continued increase in the size of securities offerings and other investment banking jobs, such as mergers and acquisitions, has shifted the probability distribution for jobs for these firms. As investment banks expect more and larger jobs to become available, firms have decided that they must expand internally, or through mergers, in order to capture more of these large jobs. As table 8 shows, firms across the industry have been growing rapidly over the past decade.

The shift in client demand and the probability distribution for jobs is the result of several factors, including the globalization of the capital and product markets. The strong economic conditions over the last ten years, particularly in the United States and Europe, have made investment banks more confident that new and successful issues will continue to be brought to the market. This supports our claim that the probability distribution for jobs has shifted toward larger and more frequent jobs. Internal expansion makes sense when firms are confident that the new resources they are hiring will be employed fully.

Today, the investment banking industry, especially those firms owned by commercial banks, has consolidated to the point where these firms now dwarf most of their clients. As investment banking firms have grown in their capital base and the number and variety of distribution channels that they control, they have obtained access to most, if not all, major market areas.²⁵³ They no longer need as many other securities firms to distribute securities in an underwriting.²⁵⁴ Thus, internal firm growth has contributed to a decline in the size and

251. McGee, *supra* note 248 (“[C]ommercial banks that have acquired Wall Street investment banks try to use their lending operations, once considered a low profit-margin business for the risks involved, as a way to win higher-margin deals of all kinds, such as underwriting. That, industry participants say, is a logical step for banks promoting a ‘one-stop shopping’ concept.”).

252. Brian Garrity & Chris O’Leary, *Relentless Forces Erode Fee Structure: Megamergers and Hyper-Competition Are Slowly Eroding Underwriting Fees*, INVESTMENT DEALERS’ DIG., Feb. 1, 1999, at 18–23.

253. BIALKIN & GRANT, *supra* note 240, at 278.

254. Sung C. Bae et al., *Determinants of Underwriter Participation in Initial Public Offerings of Common Stock: An Empirical Study*, 26 J. BUS. FIN. & ACCT. 595 (1999) (finding that a larger capital base for the lead underwriter leads to smaller offering syndicate size; if the lead underwriter has a greater number of offices, this reduces the need for a large syndicate; and the greater the prestige of the lead underwriter, the smaller the syndicate).

use of syndicates in securities offerings. As a result, in recent years the size of underwriting syndicates has declined from as many as fifty firms to between ten and twenty firms for large securities offerings.²⁵⁵ In fact, some deals are forgoing the syndication process altogether.²⁵⁶

Changes in legal rules have also influenced the use of syndicates in securities underwriting. In 1982, the SEC introduced shelf registration for securities offerings via Rule 415.²⁵⁷ This process allows companies to sell securities under a two-year blanket registration.²⁵⁸ Before this new rule, companies had to precede each security issue with a lengthy registration process. After the adoption of shelf registration, companies can hire an investment bank to distribute the securities a few days before the issue goes to market.²⁵⁹

Empirical research demonstrates that Rule 415 has accelerated the decline in syndicate size for debt offerings.²⁶⁰ Professor Foster's study establishes that syndicates in public debt offerings were significantly smaller after Rule 415 than before. He interprets his findings as "evidence in support of the notion that the investment bankers have market power. . . . Alternatively, the fewer syndicate members may simply reflect the fact that the time restrictions with a shelf-registered issue make larger syndicates more expensive."²⁶¹

Foster's second explanation—that Rule 415 increased the relative cost of syndication—is consistent with our theory. Under Rule 415, speed in doing deals became a predominant concern. Working with outside groups through syndication is time consuming. It will, for example, slow down the due diligence process. The higher relative costs of syndication will yield less syndication activity. In our model, this effect will cause some firms to grow internally to handle the large deals. These firms become less eager to syndicate, and the ripple effects cause other firms to expand.

To summarize our conclusions in this part, the use of syndication in securities offerings has varied over time, depending on shifts in

255. Garrity & O'Leary, *supra* note 252, at 18–23.

256. Brian Garrity, *Syndicate Members Receive a Sobering View of the Future*, INVESTMENT DEALERS' DIG., Jan. 25, 1999, at 18.

257. See Randall S. Thomas & James F. Cotter, *Measuring Securities Market Efficiency in the Regulatory Setting*, 63 LAW & CONTEMP. PROBS. 105, 106 (2000) (providing a general discussion of Rule 415 and shelf registration).

258. COX ET AL., *supra* note 239, at 306.

259. *Id.* at 307.

260. See F. Douglas Foster, *Syndicate Size, Spreads, and Market Power During the Introduction of Shelf Registration*, 44 J. FIN. 195 (1989) (providing an empirical study of the effects of Rule 415 on syndicate size in investment banking).

261. *Id.* at 202.

probability distribution for jobs within the industry as clients' demands and the size of the firms within the industry have changed. In addition, legal rules have influenced the relative costs of syndication versus megafirm underwriting. In recent years, as the relative costs of syndication have increased, and the importance of offering one stop shopping has grown, we have seen a decrease in the size of underwriting syndicates.

V. SECURITIES FRAUD LITIGATION AND SYNDICATION

The prosecution of securities fraud class actions provides another interesting example of how changes in legal rules can affect firm size and syndication. What is interesting and distinct about the securities industry, though, is that demand is not driven by clients, but rather by judges. Thus, we need to examine the factors that lead judges to "demand" legal services from plaintiffs' securities law firms. In particular, we highlight the impact of the 1995 Private Securities Litigation Reform Act²⁶² and the judicial introduction of auctions of the role of class counsel. Both developments should shift the probability distribution of jobs in this industry toward larger jobs. Our general model predicts that at least one firm should grow to capture more jobs. Indeed, this is the case with Milberg Weiss Bershad Hynes & Lerach (Milberg Weiss).²⁶³ Given the recent nature of these changes, however, questions remain about how other firms in this industry will react to the first firm's growth.

Securities fraud class actions arise in a wide variety of settings, but perhaps most commonly they are filed after a corporation announces unexpected bad news or insider trading, and the company's stock price falls dramatically.²⁶⁴ Many attorneys file similar suits on the same set of facts against the same set of defendants. These suits will later be consolidated by the court. Each

262. In 1995, Congress passed the Private Securities Litigation Reform Act ("PSLRA" or the "Reform Act") to try to curb some perceived abuses in the prosecution of securities fraud class actions. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995) (codified in scattered sections of 15 U.S.C.); Randall S. Thomas & Kenneth J. Martin, *Using State Inspection Statutes for Discovery in Federal Securities Fraud Actions*, 77 B.U. L. REV. 69, 70 (1997). The Reform Act contained several important provisions that affected the prosecution of securities fraud cases, and more importantly for our purposes, the allocation of work among the members of the syndicate of plaintiffs' law firms. Thomas & Martin, *supra*, at 70.

263. See *infra* note 271 and accompanying text.

264. COX ET AL., *supra* note 239, at 718-19. There is some evidence that accounting issues now outnumber other types of alleged fraud in securities class actions. See *Business Bulletin, Accounting Issues Take the Lead in Securities Fraud Class Action Suits*, WALL ST. J., July 27, 2000, at A1 (summarizing the results of a PricewaterhouseCoopers study).

lawyer filing an action stakes a claim to be given responsibility for the consolidated action. To avoid duplicate efforts, the court will select a single law firm to be “lead counsel” after hearing from all of the plaintiffs’ attorneys about who should have this plum job and how to divide up the rest of the work among the remaining law firms.²⁶⁵ Normally, plaintiffs’ counsel will voluntarily agree amongst themselves about allocating the tasks. This leads to the formation of an “ad hoc firm” through informal negotiations among plaintiffs’ counsel,²⁶⁶ which the court legitimizes after an independent evaluation.²⁶⁷

Lead counsel is a highly desirable position because this firm receives the largest share of any fees generated in the case and has the most power to control the case. Judges select lead counsel based on several criteria, including the qualifications and skill of counsel, as well as their proposed fee agreement.²⁶⁸ The courts’ objective is to ensure fair and adequate representation of the class and preserve the economy and efficiency of the proceedings.²⁶⁹ A judge generally will not appoint joint or a committee of lead counsel unless it is necessary to ensure adequacy of representation.²⁷⁰ The key point for our

265. See MANUAL FOR COMPLEX LITIGATION (THIRD), § 20.22, § 20.224, at 30 [hereinafter LITIGATION MANUAL]. “The court’s responsibilities are heightened in class action, where the judge must approve counsel for the class.” See Charles Silver, *Comparing Class Actions and Consolidates*, 10 REV. LITIG. 495, 503 (1991) (“The institutional structure of the class action is governed by law.”).

266. See *In re Agent Orange*, 611 F. Supp. 1452, 1458–59 (E.D.N.Y. 1985), for a use of the term “ad hoc law firm.” In that well-known case, the first group of plaintiffs’ attorneys ran out of funds. A new group of attorneys assumed control of the steering committee in return for their funding the case, and the two groups agreed to share fees. A dispute on the fees arose. The first group tried to invalidate the agreement based on the ethical rule barring fee splitting. The court sidestepped the ethical rule by finding that the plaintiffs’ attorneys had formed an “ad hoc law firm.” *Id.*

267. See LITIGATION MANUAL, *supra* note 265, § 20.22, at 26, 31 (stating that the court should conduct independent review; “The court’s responsibilities are heightened in class action litigation, where the judge must approve counsel for the class.”).

268. *Id.* § 20.224.

269. *Id.* at 30 (“The court should also ensure that designated counsel fairly represent the various interests in litigation; where diverse interests exist among the parties, the court may designate a committee of counsel representing different interests.”); see also *id.* § 30.16, at 221 (“[I]f necessary to ensure adequacy of representation, the court may appoint different attorneys as class counsel. . . . An important element in the selection process is economy.”); 7B CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1792, at 294 (2d. 1986) (“[T]he particular type of order a court will issue under Rule 23(d)(1) may depend on the nature of the dispute and the litigants as well as the experience of the federal courts in comparable cases.”).

270. See WRIGHT ET AL., *supra* note 269, § 1792, at 292 (“[C]ourts are often hesitant to burden the class with the additional fees and the added confusion that may result from multiple lead attorneys.”).

analysis is that judges determine which firm gets selected to become lead counsel, and thereby determine a large part of the demand for legal services.

A second important feature of this industry is that plaintiffs' securities law firms differ in important ways from the corporate law megafirms discussed earlier (who often defend securities fraud cases). The most obvious difference is how small they are. Traditionally, as shown in table 9, plaintiffs' law firms in these cases have a handful of partners. In recent years, however, one firm in the plaintiffs' securities bar, Milberg Weiss, has grown rapidly and become a diversified, relatively large law firm. This change is reflected in table 9. Indeed, since the passage of the Reform Act in 1995, Milberg Weiss has seen a substantial increase in the percentage of securities fraud class actions where it has been designated as lead counsel.²⁷¹

Third, the difference in the relationship between clients and the law firm in this industry is critical.²⁷² Clients do not usually control the litigation of these cases. In fact, law firms themselves often select the clients in order to have someone to act as the plaintiff in a suit.²⁷³ In other words, these law firms are not often concerned about client demand. Their clients are usually only interested in litigating one case, or at most a few cases, and do not offer the firms repeat business. This is especially true after the passage of PSLRA's restrictions on professional plaintiffs. Rather, as we discussed above, the firms are reacting to the demand by judges in seeking to obtain the lead counsel position for these cases.

Finally, syndication is the norm in this industry. When judges appoint lead counsel, they routinely approve the creation of a syndicate of other law firms to help handle the case. It is difficult, if not impossible, for any one firm to exclude all of its competitors from the syndicate.

271. See William S. Lerach, "The Private Securities Litigation Reform Act of 1995—27 Months Later:" *Securities Class Action Litigation Under the Private Securities Litigation Reform Act's Brave New World*, 76 WASH. U. L.Q. 597, 606 (1998) (stating that prior to the passage of the Reform Act, Milberg Weiss appeared in approximately thirty-one percent of securities fraud class actions, whereas after the Act's enactment this increased to fifty-nine percent).

272. See, e.g., Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991) (noting that "the single most salient characteristic of class and derivative litigation is the existence of 'entrepreneurial plaintiffs' attorneys . . . [which] are not subject to monitoring by their putative clients, [and] operate largely according to their own self-interest . . . and their own sense of ethics and fiduciary responsibilities").

273. *Id.* at 66.

TABLE 9: Growth of Plaintiffs' Securities Fraud Litigation Firms*

Firm Name	Size in 1990	Size in 1995	Size in 2000	Other Information
Berger & Montague	33	53	48	Office in Philadelphia, PA
Bernstein Litowitz Berger & Grossmann	11	11	24	Offices in San Diego, Hackensack, and New York City. Hackensack and San Diego offices added after 1995.
Chimicles & Tikellis	27	22	14	Offices in Wilmington and Haverford. Eliminated Los Angeles office after 1995.
Goodkind Labaton Rudoff & Sucharow	26	40	45	Offices in Ft. Lauderdale and New York City. Ft. Lauderdale office added after 1995.
Lowey Dannenberg Bemporad & Selinger	12	12	16	Offices in New York City and White Plains. White Plains office added after 1995.
Milberg Weiss Bershad Hynes & Lerach	60	88	126	Offices in Los Angeles, San Diego, San Francisco, New York City, Boca Raton, FL. Firm added San Francisco, Los Angeles, New York, and Boca Raton offices after 1990.
Savett Frutkin Podell & Ryan	N/A	4	4	Established in 1991. Office in Philadelphia.

*Note: Size includes partners, associates, and of counsel in all offices
Source: MARTINDALE-HUBBELL LAW DIRECTORY (2001).

The next two parts illustrate how the Reform Act and auctions of the lead counsel position have affected, or could affect, this industry's structure.

A. Securities Fraud Litigation and the Lead Plaintiff Provision

Congress enacted the Reform Act in 1995 to deter entrepreneurial plaintiffs' law firms from filing frivolous securities fraud cases.²⁷⁴ The statute contains several provisions which make it more difficult, expensive, and risky for law firms to pursue these cases. These provisions have both demand-side and supply-side effects. Most important for our demand-side focus is the Reform Act's lead plaintiff provision.²⁷⁵ Congress created a presumption that the firm representing the shareholders with the largest financial interest should be designated lead counsel for the class.²⁷⁶ The provision was intended to create real clients for these lawsuits, and in

274. See, e.g., Thomas & Martin, *supra* note 262, for a general discussion of the Reform Act's provisions.

275. *Id.* at 77-78.

276. See 15 U.S.C. § 77z-1(a)(3)(B) (Supp. V 1999).

particular to attract institutional investors as the lead plaintiffs.²⁷⁷ In fact, institutional investors have been extremely reluctant to get involved in this type of litigation for a variety of reasons.²⁷⁸

Instead, the statute has become a case allocation mechanism with significant consequences for the plaintiffs' securities bar. The lead plaintiff provision has shifted the structure of the law firm syndicate litigating these cases by giving the winning firm the position of lead counsel and a larger share of the work generated in the case, while leaving other firms with a reduced role in the syndicate. It has caused plaintiffs' law firms to compete vigorously to attract the largest shareholders as clients. While the federal courts have split over how to determine the number of shares represented by a firm,²⁷⁹ under any

277. Elliott J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2105-06 (1995).

278. Commenting on the lead plaintiff provision of the Private Securities Litigation Reform Act of 1995, some scholars have noted that it may prove to be an obstacle to certain actions:

The lead plaintiff provision was intended by Congress to be a means by which shareholders could be put in charge of securities class actions. In practice, however, the lead plaintiff provision could become another obstacle to federal securities class actions. Extended disputes over lead plaintiff status, while creating delay and expense, produce little tangible benefit for the class. In this regard, we note that the Reform Act does not include lead plaintiff motion papers among the pleadings and papers that are subjected to mandatory Rule 11, Federal Rules of Civil Procedure, scrutiny. Absent a meaningful threat of sanctions for meritless objections to lead plaintiff status, plaintiffs and their lawyers have every reason to tie institutional investors up in lead plaintiff battles. Worse yet, if other courts follow the *Cephalon* court's lead in allowing wide-ranging discovery without any showing of a reasonable basis that the institution can not adequately represent the class, institutions could be discouraged from intervening in securities class actions as Congress intended. The legislative history suggests that Congress believed institutions would readily step forward once they were armed with the new lead plaintiff provision. Our discussions with institutional investors, however, suggest that there are substantial disincentives for institutional investors considering intervention in securities class actions. Those disincentives fall into two categories: cost and exposure. As the Reform Act allows plaintiffs to conduct discovery of other plaintiffs, institutions may find key personnel being subjected to costly and time-consuming discovery by plaintiffs and then to a second round of discovery by defendants. Moreover, private institutional investors, such as investment companies, may be forced to open their books during discovery revealing proprietary information. In addition, many institutions may not want to advance the costs of litigation for the class. Adding to the expense is the time needed to manage the litigation.

Richard H. Walker et al., *The New Securities Class Action: Federal Obstacles, State Detours*, 39 ARIZ. L. REV. 641, 664-65 (1997).

279. See Jill E. Fisch, *Aggregation, Auctions, and Other Developments in the Selection of Lead Counsel Under the PSLRA*, 64 LAW & CONTEMP. PROBS. 53, 65-78 (2001); Jill E.

interpretation, the provision creates strong incentives for plaintiffs' law firms to try to attract clients with big blocks of stockholdings. Firms have responded to these new rules by racing to publish their role in these cases to attract clients.²⁸⁰

In our model's terminology, the firm with the most client demand (most shares represented) gets the biggest piece of the job. To the extent that judges strictly enforce its requirements, it removes some of their discretion in determining which firm is lead counsel and makes client demand more important. Moreover, if bigger firms can attract bigger clients, they will have an advantage in getting the lead counsel position.

This provision also affects the terms of the negotiation between the plaintiffs' law firms over the allocation of work within the syndicates that handle these cases. If one firm, say Milberg Weiss, most frequently captures the lead counsel positions in these cases, then when other firms become lead counsel they have an incentive to give Milberg Weiss preferential treatment to curry favor with this dominant player. Thus, if one firm wins most lead counsel assignments, it will also get a bigger share of the work in syndicates where it is not lead counsel. As a result of these dynamics, the Reform Act may create incentives for plaintiffs' securities fraud law firms to become bigger if firm growth leads them to attract larger clients and garner more lead counsel assignments.

The lead plaintiff provision has another important effect: early work in a case may not be rewarded. Even if a law firm finds and develops a strong case and files a well-drafted complaint, it may still wind up without a role in the litigation if another firm shows up with a client that has a larger stake in the company being sued. Losing law firms therefore face higher sunk costs than prior to the Reform Act. This is an important supply-side factor affecting firm structure.

In addition to the lead plaintiff provision, the Reform Act has other features that raise the cost of prosecuting these cases and increase the litigation risks. First, the statute raises the pleading standard for securities fraud suits brought under the 1934 Exchange

Fisch, *Class Action Reform: Lessons from Securities Litigation*, 39 ARIZ. L. REV. 533, 549 (1997).

280. One example of this competition is the increased use of firm web sites as a method of attracting potential shareholders. Milberg Weiss's web site is the best example of how firms compete in this regard. See generally MILBERG WEISS BERSHAD & LERACH LLP, *Representing Consumers and Investors in Class Actions*, at <http://www.milberg.com> (last visited Nov. 15, 2001) (on file with the North Carolina Law Review).

Act.²⁸¹ To achieve its objective, Congress declared that a federal securities fraud complaint must: (1) specify each statement alleged to have been misleading and the reasons why the statement is misleading; and (2) if an allegation is made on information and belief, state with particularity all facts upon which that belief is formed.²⁸² Furthermore, the complaint must state with particularity facts giving rise to a strong inference that the defendant acted with the requisite scienter, or intent to defraud, with respect to each alleged wrongful act or omission.²⁸³ This latter requirement codifies a state of mind standard of pleading that is based on the Second Circuit's decisions, a standard that is generally regarded as the most stringent pleading requirement among the federal circuits.²⁸⁴ This means that firms need to invest substantially more resources and manpower in investigating each case thus raising the cost of filing a case. From an economic perspective, this change leads to higher sunk costs because of the need to investigate the case and spend money on accountants and investigative agents.

Second, PSLRA stays discovery until after the resolution of the defendants' motion to dismiss the complaint.²⁸⁵ This increases the likelihood that a case will be dismissed, wasting the resources already invested. One commentator has reported that the plaintiffs' law firms are losing about fifty percent of the motions to dismiss in securities fraud cases.²⁸⁶ The numbers are much more one-sided in Silicon Valley with the federal courts granting virtually all motions for dismissal.²⁸⁷

Third, the statute restricts the use of "professional plaintiffs," that is, law firm clients who act as the named plaintiff in many suits

281. In deciding to enact PSLRA, Congress made clear that it believed that the Federal Rules' of Civil Procedure generous pleading requirement failed to deter private litigants from abusing the federal securities laws. See Thomas & Martin, *supra* note 262, at 75. Congress determined that a uniform and more stringent pleading requirement was needed to curtail the filing of meritless lawsuits. *Id.*

282. 15 U.S.C. § 78u-4(b)(1) (Supp. V 1999).

283. *Id.* § 78u-4(b)(2).

284. Thomas & Martin, *supra* note 262, at 75.

285. PSLRA requires that all discovery be stayed during the pendency of a motion to dismiss a securities fraud complaint brought under the 1933 Securities Act or the 1934 Exchange Act. 15 U.S.C. § 77z-1(b)(1)-(4) (Supp. V 1999). The sole exception is where the court finds that the discovery is needed to preserve evidence or to prevent undue prejudice to a party. *Id.* § 77z-1(b)(2). For defendants that succeed in getting the action dismissed, this change will greatly reduce the costs of defending the lawsuit. For plaintiffs, however, it means that in most cases they must seek evidence of fraud without the assistance of the court. Thomas & Martin, *supra* note 262, at 76.

286. Lerach, *supra* note 271, at 615.

287. *Id.*

each year.²⁸⁸ This makes it necessary for a plaintiffs' law firm to have a larger client base so that they can find people to act as the nominal plaintiff in the cases they file.

Fourth, PSLRA raises the stakes if the court chooses to impose sanctions against plaintiffs and their counsel for violations of Federal Rule of Civil Procedure 11.²⁸⁹ The Reform Act adopts a limited form of the English rule on fee shifting, thereby making the plaintiffs liable for the defendants' costs and attorneys fees if they are sanctioned by the court.²⁹⁰ The threat of sanctions puts firms' capital at risk if they file a suit that a court finds frivolous.

Each of these provisions reduces the incentives that plaintiffs' law firms have to undertake securities fraud cases, especially weaker cases. Taken as a whole, the Reform Act increases the cost of researching and prosecuting any securities fraud complaint,²⁹¹ and it raises the risk that the law firm will receive nothing for its efforts. The Reform Act may also increase law firm capital needs, and make it more important to have a diversified portfolio in order to spread the risks. Higher costs and greater risk can have the effect of leading weaker firms to exit the industry, leaving the remaining firms with a larger market share.²⁹² These supply-side factors are important

288. PSLRA contains a number of provisions designed to stop the use of professional plaintiffs, including requirements that: (1) each named plaintiff in the action certify, *inter alia*, that they did not purchase the security at the request of their attorney to participate in the lawsuit; (2) notice of the pendency of the action be published in a national business publication or wire service; (3) bounty payments or other bonuses to named plaintiffs are prohibited; and (4) discourage courts from allowing a person to be a lead plaintiff in more than five securities fraud cases during any three year period. 15 U.S.C. § 77z-1(a)(2)(A) (Supp. V 1999).

289. PSLRA requires courts to make specific findings concerning each party's and attorney's compliance with Rule 11's requirements. 15 U.S.C. § 77z-1(c)(1) (Supp. V 1999). If the court finds that there has been a violation of Rule 11, it is required to impose sanctions with reasonable attorneys' fees and expenses presumed to be the appropriate sanction. *Id.* § 77z-1(c)(2). If the complaint "substantially fails" to comply with Rule 11, the amount of this award is unlimited. *Id.* § 77z-1(c)(3)(A)(ii).

290. Thomas & Martin, *supra* note 262, at 78.

291. We recognize that there are numerous other provisions of PSLRA that reduce the attractiveness of bringing these cases, including safe harbor provisions for forward-looking statements, limitations on recoverable damages, changes to defendants' proportionate liability and settlement rights, and exclusion from the RICO statute of securities fraud as a predicate act, and revised auditor reporting obligations. For further discussion of these provisions, see John W. Avery, *Securities Litigation Reform: The Long and Winding Road to the Private Securities Litigation Reform Act of 1995*, 51 BUS. LAW. 335 (1996).

292. Lerach attributes Milberg Weiss's success to its ability to best address these changes: it is the best capitalized plaintiffs' firm and can therefore withstand the costs and delays associated with the Reform Act; it has the most diversified portfolio of plaintiffs' claims and can therefore absorb the greater risks associated with litigating cases under the Reform Act; and that it is best situated "to internalize the externalities associated with the

determinants of firm structure.

The limited empirical evidence that we have been able to muster suggests that PSLRA has significantly affected firm structure in the plaintiffs' securities fraud bar. As table 9 reveals, Milberg Weiss has grown much more than the other firms in the area. The most salient fact is the significant increase in the number of cases where Milberg Weiss is designated as lead counsel. Bill Lerach estimates that his law firm appears in about sixty percent of the securities fraud class actions filed since the passage of the Reform Act.²⁹³ In a small data set that we gathered for post-Reform Act cases, we found that this firm was named lead counsel in forty-one of sixty-three cases (about sixty-five percent) where we could determine who was appointed lead counsel. Milberg Weiss's success in obtaining the role of lead counsel has been accompanied by significant growth in the size of this law firm.²⁹⁴ In other words, Milberg Weiss has been able to capture a larger share of the bigger jobs and appears to have expanded its firm so that it can handle this work internally.

Our model predicts that other firms should react to Milberg Weiss's growth if this growth allows it to capture more clients and to reduce the remaining firms' opportunities to get the lead counsel position. Yet, no other firm in this industry that we are aware of has grown as rapidly as Milberg Weiss. While at first this seems puzzling, we believe that there are several reasons why the expected growth may not yet have occurred. First, the passage of the Reform Act is still fairly recent so that firms may still be in the process of reacting to its effects. Second, the main driving force for law firm growth in this industry would be to capture more lead counsel assignments by taking advantage of the lead plaintiff provision's presumption that the class member with the largest financial interest should be able to direct the litigation. Firms may be able to attract these clients through other techniques without increasing their size, such as generating a reputation for quality outcomes or appealing to certain types of investors. In other words, boutique firms may not suffer from being small in this competition with a larger firm to attract clients. Finally, small size firms may find non-economic factors, such as collegiality and firm culture, particularly important. These may lead the other plaintiffs' law firms to reject the growth paradigm and prefer to remain boutique firms. They do not need to fear a complete loss of

need to invest to create new precedent interpreting the [new law]." Lerach, *supra* note 271, at 606.

293. *Id.*

294. See table 9 for evidence of such growth.

business as long as judges continue to routinely approve syndication of these cases. We conclude that there may be good reasons why the other firms in the plaintiffs' securities bar have not reacted to Milberg Weiss's growth by engaging in their own internal expansion.

B. Auctions of Lawsuits

Beginning with *In re Oracle Securities Litigation*²⁹⁵ in 1990, several courts have auctioned the role of lead counsel in securities fraud class actions among competing law firms.²⁹⁶ In the *Oracle* litigation, Judge Walker instructed the law firms that were competing for the position of lead counsel for the stockholder class to submit sealed litigation budgets, including reimbursable litigation expenses and the percentage of the judgment that counsel would require to take the case.²⁹⁷ A well-qualified firm offered to handle the case for the lowest fee, and Judge Walker awarded them the job of litigating the lawsuit.²⁹⁸

While in subsequent auctions the terms have varied somewhat from case to case, they generally result in single firms winning the bid and handling the case. Thus, the most interesting consequence of auctions from our perspective is that auctions may cause judges to award one firm the entire suit, and thus may eliminate the syndication

295. *In re Oracle Securities Litigation*, 131 F.R.D. 688 (N.D. Cal. 1990).

296. For further discussion of the pros and cons of auctions of lawsuits, see Randall S. Thomas & Robert G. Hansen, *Auctioning Class Action and Derivative Lawsuits: A Critical Analysis*, 87 NW. U. L. REV. 423 (1993). There is an extensive literature concerning the merits of auctions of the lead counsel position in lawsuits. For a thorough review of this literature, see Jill E. Fisch, *Lawyers on the Auction Block: Evaluating the Selection of Class Counsel by Auction* 102 COLUM. L. REV. (forthcoming Apr. 2002) (concluding that auctions should be abandoned and replaced with negotiations with "empowered" lead plaintiffs).

297. See *In re Oracle*, 131 F.R.D. at 690-91. The principal advantage of Judge Walker's proposal for auctioning the lead counsel position is that it increases the winning attorney's incentives to invest in case preparation because she will not have to share the expected profit of prosecuting the action with other attorneys. John C. Coffee, Jr. *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROBS. 5 (1985). However, this procedure has serious drawbacks. For example, if the court awards the case to the lowest cost attorney, the unintended consequence may be that the least competent counsel, who had the lowest costs, wins the bid. To the extent that lawyers' fees reflect their demand by the market, it seems an undesirable consequence of this method that it could allocate these cases to the worst attorneys. *Id.* at 61-65. Furthermore, as Macey and Miller note, this technique reintroduces significant agency costs because the winning attorney will have incentives to settle early to obtain a larger profit on the fee. Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1, 113 (1991); see also Coffee, *supra*, at 77-78.

298. *In re Oracle*, 132 F.R.D. 538, 546-47 (N.D. Cal. 1990).

of lawsuits among various law firms. Auction winners will tend to get more business, while other firms will get less. How will firms react to such a regime if it is adopted on a routine basis?

In our terminology, the nature of judicial demand for law firm services would have changed. Judicial auctions shift the probability distribution of jobs towards larger projects, as the judge allows (or perhaps prefers) the winning bidder to handle the entire case. Each individual job will be bigger for the winning firm because it can staff the entire case itself without being forced to share the work with firms representing other plaintiffs. Our model predicts that this should create incentives for firms to get bigger, as the Milberg Weiss firm has already done.

Judicial auctions could allow bids from a consortium of firms. If this were allowed, syndication would still be possible. Whether these syndicates could outbid single firms in auctions is impossible to predict. In a competitive market, the equilibrium outcome will depend on how the single firm's internal costs of expansion compare with the syndication costs incurred by the consortiums of smaller firms. The key point is that the auction model could allow the market to make the choice between syndication and megafirm, whereas the prior legal regime required syndication.

Our model offers one important insight into how competition between smaller and larger firms would play out in a world of auctions. If the same economics apply to plaintiffs' law firms that we discussed in Part II for larger diversified law firms, then we might anticipate that the larger firms will win out over the syndicate of smaller firms once the traditional legal rule that led to syndication is removed. This is certainly what happened in many other legal markets.

The one caveat to this prediction is that pure play firms continue to serve an important role in certain specialty legal practices. Securities fraud litigation may be one of those areas. If small firms can win auctions based on a reputation for producing quality results for the class, they may be able to compete with the bigger firms. However, to the extent that they need larger amounts of capital to compete effectively, perhaps because of the passage of the Reform Act and its provisions, smaller firms face a significant competitive disadvantage. Thus, legal reforms could inadvertently create larger plaintiffs' law firms.

CONCLUSIONS

Firm structure in the project industries we study—law, accounting, and investment banking—responds to both demand-side and supply-side factors. While many scholars have identified important supply-side determinants, little attention has been paid to the demand-side.

Our model addresses that oversight. In these project-oriented industries, a key determinant of firm size is the size distribution of projects demanded by clients. No firm will find it profitable to be as large as necessary to internally service the largest projects if these projects come too infrequently to justify the fixed costs of internal expansion. Rather, firms will choose their size recognizing that syndication with other firms is a viable alternative way of servicing these projects. In determining its size at any point in time, a firm must balance the internal costs of expansion against the external costs of syndication. In addition, legal constraints against combining practices can limit the growth of firms.

Megafirms arise as the demand distribution of projects shifts towards larger projects. All the industries examined here—law, accounting, and investment banking—have seen this shift in demand. Global corporations demand global projects from their lawyers, accountants, and investment bankers. Many clients are willing to pay for one-stop shopping. Supply-side factors, such as improvements in technology, may lower costs and encourage firm growth also. As a result, megafirms have appeared in each industry. Further, this client demand for larger, multidisciplinary projects is putting pressure on ethical restrictions against servicing them with a single, multidisciplinary firm.

Megafirms have their limits. They may be approaching their limits in the accounting industry. Most of the Big Five firms are facing enormous internal costs (as well as outside regulatory pressure) in holding their accounting and consulting parts together. Some form of syndication of accounting and consulting services (or sharing between separate entities) may end up being the equilibrium form of organization in these industries. By contrast, law firms do not yet appear to have reached a point where increased internal costs outweigh the benefits of future expansion. We would expect to see more consolidation in that industry in the years to come.

Legal rules also shape megafirms. Some legal rules hinder megafirms and lead to syndication as an alternative. The ABA's ethical rules against lawyers mingling with others have clearly

inhibited the growth of multidisciplinary law-accounting firms in this country. MDPs are more advanced in Europe, where the regulations are more lax. The SEC's rules on accounting independence similarly hamper the Big Five megafirms, possibly causing several of them to separate their auditing and consulting practices.

Other legal rules bolster megafirms. We saw this most clearly in the investment banking and securities fraud litigation examples. Shelf registration under Rule 415 has spurred the growth of investment banking megafirms and the decline of underwriting syndicates. The lead plaintiff provisions in the Reform Act (and potentially auctions of the lead counsel role in these cases) appear to have helped create a mega-law firm, and changed the structure of that industry.

Our model is very flexible and offers a wide variety of potential applications and predictions for firm structure and its effect on legal rules. We believe that there is much more work to be done in these areas. In particular, we see a need to empirically test more of the propositions that we develop in this Article. This is a fruitful area for further research.