

## The Partnership Penalty?

Scott Baker\* & Kimberly D. Krawiec\*\*

The choice of organizational form for business and professional service firms has been of great interest to lawyers and economists for many years. The law offers parties a variety of choices, including general partnerships (GPs), limited partnerships (LPs), limited liability partnerships (LLPs), limited liability limited partnerships (LLLLPs), limited liability companies (LLCs), and, of course, corporations. Each organizational form has its own set of default rules, governing everything from the distribution of profits to dissolution. Within each business form, parties can alter most of the default rules governing the arrangement.

The GP is the ultimate default regime for businesses operated by more than one person. If two or more parties run a business for profit and do nothing else, the GP default rules apply.<sup>1</sup> The case law is full of situations where parties unintentionally entered into a business and ended up a partnership.<sup>2</sup>

At first glance, many of the partnership default rules appear unattractive. In a GP, for example, each partner is personally liable for the debts of the partnership.<sup>3</sup> Besides the rule of unlimited liability, the GP form has a number of other unattractive default

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\* Associate Professor of Law, University of North Carolina; email: sbaker@email.unc.edu

\*\* Bruce W. Nichols Visiting Professor, Harvard Law School; Professor of Law, University of North Carolina; email: kkrawiec@email.unc.edu

<sup>1</sup> See *White Consul. Indust., Inc. v. Waterhouse*, 158 F.R.D. 429, 434 n.7 (D.Minn. 1994) (stating that, “whether a legally binding partnership has been formed is a question of fact which can be inferred from the partners’ actions. We are aware of no requirement that, in order to verify its formation, a partnership agreement must be filed with the State[.]”); Uniform Partnership Act (1914) (“U.P.A.”) § 6 (defining “partnership”); Revised Uniform Partnership Act (1997) (“R.U.P.A.”) §§ 101(4), 202 (defining “partnership”). In what follows, we will note situations in which the U.P.A. and the R.U.P.A. default rules differ.

<sup>2</sup> See *Reddington v. Thomas*, 45 N.C. App. 236, 262 (1980); *Bass v. Bass*, 814 S.W.2d 38 (Tenn. 1991); *Howard Gault & Son v. First Natl. Bank*, 541 S.W.2d 235, 237 (Tex. Civ. App. 1976). On the formation of partnerships, see generally ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP § 2.05 (Aspen 2003) (hereinafter BROMBERG & RIBSTEIN “Partnership”).

<sup>3</sup> U.P.A. §§ 13-15; R.U.P.A. §§ 304, 306

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rules. These defaults include: (1) the rule that profits and losses be split equally among the partners, (2) the one partner/one vote rule, and (3) the guarantee of a partner's right to seek a buyout.<sup>4</sup>

Despite these seemingly unattractive default rules, several theories have emerged regarding the desirability of the partnership form. These arguments can be divided into three broad categories: (1) arguments based on profit-sharing; (2) arguments based on the illiquid nature of a partnership interest; and (3) arguments based on the unlimited liability of the GP form. The first two categories of explanations apply to partnerships generally, whereas the third argument – unlimited liability – is a justification for the GP form, in particular.

In this Article, we pose an additional theory regarding the desirability of the GP form: a penalty default argument. In other words, the GP default rules may make sense – and may, in fact, be socially desirable – because they penalize parties who fail to formalize their arrangements, either by affirmatively choosing an organizational form that requires notification to the state, or through elaborate contractual drafting. In the terms familiar to contract law scholars, the entire general partnership regime may operate as an information-forcing default rule.

The state may desire such information forcing from business and professional service firms for a variety of reasons. First, if parties must explicitly resolve many important issues -- such as, for example, the division of profits – through careful

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<sup>4</sup> R.U.P.A. § 401 (b) (default rule on profit and losses); R.U.P.A. § 401(f) (default rule on management responsibilities); R.U.P.A. § 29 (default rule on partner buyouts). These default rules can be circumvented or ameliorated in several ways. First, and most obviously, the parties can opt for another organizational regime, such as the LLC or corporate form. Second, the default rules other than limited liability can be altered through a detailed partnership agreement. Finally, the rule of unlimited liability can be ameliorated through contract and insurance.

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negotiation and drafting, the information gathering burden on courts. Second, state notification of the existence of a for-profit firm enables the state to take certain actions with respect to that firm. For example, the state can more easily tax and regulate for-profit firms when it has been alerted to their existence.<sup>5</sup>

In the last fifteen years, all 50 states have passed laws that permit the formation of an LLP.<sup>6</sup> To become an LLP, a general partnership need only file a form with the secretary of state, pay a nominal fee, and comply with a few other formalities.<sup>7</sup> If the partners want, the old partnership agreement can continue to govern the newly formed LLP. The major difference between the GP and the LLP is that, in the LLP, the partners are liable only for debts stemming from their own conduct, or the conduct of someone under their supervision.<sup>8</sup>

The creation of the LLP form allows for a natural experiment of the theories advanced regarding the benefits of the partnership form. To test these theories, we collected data on the 80 law firms listed in Martindale-Hubble as having their primary offices in New York, New York and more than 75 lawyers. Since 1994, these law firms have had a choice of whether to remain a GP or adopt LLP status.

If the theories asserting that profit-sharing and illiquidity are the primary reasons for the existence of partnerships are true, then most or all of the firms in our sample

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<sup>5</sup> See Larry E. Ribstein, *Why Corporations?*, Univ. of Illinois Law and Economics Working Paper 33-\_\_\_ (2003) (hereinafter, Ribstein “Corporations”).

<sup>6</sup> See ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG & RIBSTEIN ON LIMITED LIABILITY PARTNERSHIPS, THE REVISED UNIFORM PARTNERSHIP ACT, AND THE UNIFORM LIMITED PARTNERSHIP ACT (2001) 15 (Aspen 2003) (hereinafter Bromberg & Ribstein “Limited Liability”). Some states, including New York, California, Nevada and Oregon, only offer LLP status to professional firms.

<sup>7</sup> See, e.g., NY Partnership Law § 121-1500.

<sup>8</sup> See Bromberg & Ribstein, Limited Liability, *supra* note 6, at § 1.02. States differ in the limitations on liability provided by LLP status. Some states limit liability for all claims, whether rooted in contract or tort. See, e.g., [cites]. Others states limit liability for selected types of tort claims. See BROMBERG & RIBSTEIN, LIMITED LIABILITY, *supra* note \_\_\_, at 2-17 (discussing the variations among state LLP statutes).

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should have opted for the LLP form, as it provides all of the same benefits of profit sharing and lack of liquidity, without the costs of unlimited liability. In contrast, if the theories asserting unlimited liability as the primary benefit of the partnership form are true, then a majority of firms should remain GPs, or the firms should break down regarding choice of organizational form on some observable criteria. Finally, if the penalty explanation is valid, then all or most firms should opt for the LLP form.

Contrary to our expectations, a sizeable number of firms -- about fifteen percent -- remain GPs. Seventy-nine percent have become LLPs.<sup>9</sup> This mix is puzzling. Our analysis shows no significant variation based on number of lawyers or number of offices. Furthermore, on the surface, the difference between these firms is minimal. Each has a sophisticated practice, with sophisticated clients. They each provide roughly the same “product” -- namely high-end legal services. The movement of most firms to LLP status and the lack of a clear relationship between individual firm characteristics and choice of organizational form raise questions about the value of unlimited liability, at least as applied to law firms. However, the fact that a sizeable number of firms remain GPs undermines the explanations based on profit sharing and illiquidity as well. Because unlimited liability is the only meaningful distinction between the GP and LLP, unless many sophisticated law firms suffer from extreme inertia, it must be unlimited liability, rather than profit sharing or illiquidity, that at least some firms perceive as valuable.

At the same time, however, the fact that many law firms remain GPs and that the choice between GP and LLP fails to divide along coherent lines is troubling for the

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<sup>9</sup> The other six percent of the firms are PCs. For reasons discussed in more detail in Part IV, we decided to drop the PC firms from our sample.

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penalty analysis as well. If unlimited liability is truly a penalty, then why are some of the most legally sophisticated firms in the United States voluntarily choosing it?

To cast light on this puzzle, we supplement the empirical analysis with interviews of partners at many of these large New York law firms that have not chosen LLP status. The asserted reasons for each firm's choice of organizational form are telling and indicate that, for many partners, the perceived benefits of unlimited liability are real. At the same time, however, the interviews indicate that this view is changing, particularly among younger partners, and that most of those interviewed believe that full movement into the LLP form is inevitable.

Unfortunately, this conclusion leads to yet another mystery. If unlimited liability is perceived as a penalty by law firms, then why did law firms limit their own access to limited liability organizational forms until the mid-1990s? Before the creation of the LLP and LLC, law firms that wanted to capture the benefits of the partnership form had to agree to unlimited liability.<sup>10</sup> During that same time, for many professional firms, corporate status -- and limited liability -- was not available.<sup>11</sup> Although these prohibitions were contained in state laws and judicial rulings, these restrictions were derived from rules of the governing professional organizations that restricted the choice of form and prevented incorporation. It was these professional firms -- in particular law firms -- who were at the forefront of the debate over the passage of the LLP statutes.

Interestingly, rather than petition the ABA to change the ethical rules to permit

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<sup>10</sup> The potential benefits of the GP form, in addition to the theories regarding the benefits of unlimited liability, include: its greater flexibility and its relative lack of regulation vis-à-vis corporations. Ribstein at 34.

<sup>11</sup> Discussion of the PC form is explored fully in Part IV. The liability restrictions associated with the PC form were imprecise, especially as applied to law firms. For the rest of the discussion, reference to "incorporation" means incorporation under the general corporate law statute.

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incorporation, law firms lobbied the state legislatures to apply limited liability rules to partnership.<sup>12</sup> And by obtaining passage of the LLP statute, law and other professional firms were able to secure the benefits of limited liability, without suffering the disclosure, regulatory, and tax implications associated with incorporation.

Perhaps counter-intuitively, we hypothesize that the ABA rules restricting law firm form may serve as a barrier to entry for new law firms. Without limited liability, all firms will be forced to purchase insurance in order to ensure their survival. However, because new firms have less experience and have yet to demonstrate that they are a good insurance risk, such insurance is more costly to them. Accordingly, it is more expensive for new competitors to enter the market under an unlimited liability regime than under a regime of limited liability.

This article proceeds as follows. Part I reviews the theories that have been advanced regarding the desirability of the partnership form. These theories can be roughly divided into three categories: (1) explanations based on profit sharing, (2) explanations based on the illiquidity of partnership interests, and (3) explanations based on unlimited liability. We demonstrate that there are two problems with explanations for the partnership form based on profit sharing or illiquidity. First, the partnership form is unnecessary to provide these purported benefits. Both profit-sharing and illiquidity can be, and frequently are, replicated through a variety of organizational forms, including the LLC, PC, and corporation. Second, the choice of organizational form among law firms in our sample cannot be explained by reference to the profit sharing and illiquidity explanations. Therefore, either inertia or the perceived benefits of unlimited liability

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<sup>12</sup> *C.f.* Donald J. Weidner, *Pitfalls in Partnership Law Reform: Some United States Experience*, 26 J. CORP. L. 1031, 1033-34 (detailing the development of the LLP through state legislatures, rather than through the Revised Uniform Partnership Act.)

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must be the relevant explanation for the choice of organizational form among firms in our sample.

Part II lays out the argument that the GP default rules serve as a penalty default, forcing partners to formalize their arrangement with each other and to the rest of the world. Part III presents our empirical study of the structure of large law firms in New York, both the initial data and interviews with partners. Part IV questions the ethical rules that prevent law firms from incorporating. Part V concludes.

## I. Theories of the Partnership Form

Four reasons are traditionally advanced as rationales for the partnership form: (1) insurance; (2) monitoring; (3) generating trust and collegiality; (4) quality signaling; (5) preventing grabbing and leaving; and (6) providing incentives to mentor. As discussed in greater detail below, each of these rationales is dependent on one of three characteristics associated with partnerships: profit-sharing, a characteristic of both GPs and LLPs; illiquidity, a characteristic of both GPs and LLPs; and unlimited liability, a characteristic of the GP, but not the LLP. As will be shown in Part III, rationales based on any of these considerations are undermined by the empirical data on the choice of organizational form of New York law firms.

In this Part I, however, we also demonstrate that explanations based on profit sharing and illiquidity cannot be a rationale for the choice of the GP form over the LLP, as profit sharing and illiquidity are characteristics of both the LLP and GP forms.<sup>13</sup>

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<sup>13</sup> In fact, neither the profit-sharing motivation nor the illiquidity explanation is a persuasive explanation for the choice of *any* partnership form, much less the GP form. Contrary to the assumptions of many economists, profit-sharing is not a unique characteristic of the partnership form and can be easily accomplished through an LLC or corporation, albeit with greater transaction costs in the case of the

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Accordingly, were it the case that any of the rationales based on profit sharing or illiquidity are the primary motivation for the choice of organizational form, then all of the law firms in our sample should have opted for the LLP form during the past ten years, as doing so is inexpensive, easy, and still provides all of the benefits of profit sharing and illiquidity. As this is not the case, we reject in this section all of the justifications for partnership based on profit-sharing and liquidity explanations.

In contrast, justifications for the partnership choice based on unlimited liability explanations could explain the choice of organizational form among New York law firms. However, the empirical data undermines each of these potential explanations, as the breakdown among firms fails to conform to the predictions of such explanations. Accordingly, we reject in Part III of this paper all of the justifications for partnership based on unlimited liability explanations.

#### A. Insurance

The insurance argument starts by noting that professionals make significant investments in human capital.<sup>14</sup> Such investment is hard to diversify and, hence, risky. Further, an insurance market for human capital does not exist because of moral hazard and adverse selection.<sup>15</sup> Consider a lawyer who invests heavily to become a skilled bankruptcy attorney. The return on the lawyer's investment is linked to the demand for bankruptcy work. If, for instance, there is a prolonged economic boom, the return on the

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corporation. In addition, illiquidity is a common characteristic of LLCs and close corporations as well and, through the use of standard-form restrictions on resale, these investments can be made just as illiquid as the partnership interest.

<sup>14</sup> For formal articulations of the insurance argument see Kevin Lang & Peter-John Gordon, *Partnerships as Insurance Devices: Theory and Evidence*, 26 RAND. J. OF ECON. 614 (1995) and Martin Gaynor & Paul Gertler, *Moral Hazard and Risk Spreading in Partnerships*, 26 RAND J. OF ECON. 591 (1995).

<sup>15</sup> Moral hazard refers to the fact that a party who is fully insured will not take adequate precautions to avoid the insured-against event. For example, the homeowner who has purchased full fire insurance may be more inclined to smoke in bed. Adverse selection refers to the fact that parties selecting insurance might be particularly susceptible to suffering the insured-against event.

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lawyer's investment is small. The lawyer cannot mitigate this risk through insurance. Any insurer would feel uncomfortable writing a policy that paid out when an attorney's business was slow -- fearing moral hazard on the part of the attorney.

How, then, does the bankruptcy attorney insulate herself from risk? According to many economists, she teams up and forms a partnership with other attorneys. The partnership allows the attorney to share profits with attorneys in different areas. Through profit-sharing, the attorneys diversify their individual investments in human capital. Moral hazard remains a problem, however, because a partner might shirk, knowing that she will still recoup income through profit-sharing. Nonetheless, economists argue that the partners in a professional firm are better able to monitor (and therefore control) moral hazard than outside insurers.

For the sake of analysis, we accept the premises of the insurance argument that profit-sharing is useful because it reduces the risk of human capital investment and partners are better than outside insurers at controlling moral hazard. From these premises, however, the choice of *any* partnership form, much less the GP form, does not inevitably follow.<sup>16</sup> In particular, the insurance argument fails to explain why some firms in our sample select the GP form, while others opt for LLP status, as the insurance characteristics of both organizational forms are exactly the same.<sup>17</sup>

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<sup>16</sup> A corporation, LLC, or PC could all share profits in the same way as a partnership. Although such profit-sharing arguably entails higher transaction costs in the corporate form, it is not clear that those costs outweigh the benefits of limited liability provided by the corporate form.

<sup>17</sup> In addition, the insurance justification for partnership implicitly assumes that there are just two ways to reduce the risks of human capital -- insurance and profit-sharing. An appropriately structured investment portfolio, however, might also reduce this risk. A lawyer, for instance, could invest in companies that are apt to be profitable when the return on her human capital is likely to be small. Such portfolio construction entails transaction costs. At the same time, however, the lawyer avoids the monitoring costs associated with profit-sharing, whether the profit-sharing arises in a LLC, a general partnership, a close corporation, or a professional corporation.

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## B. Monitoring Fellow Partners

The monitoring justification for the existence of partnership takes two different forms, one based on profit-sharing and the other based on unlimited liability. As discussed in this section, however, neither version provides a convincing explanation for the choice between GP and LLP status observed in the data.

### 1. Profit-Sharing and Monitoring

In an early article on this subject, Armen Alchian and Harold Demsetz propose that employee-ownership is useful when it is hard to monitor the employee's input in the production process.<sup>18</sup> By, in effect, making each employee a residual claimant on profits, the employee-owned firm induces monitoring of each employee by every other employee. The inability to monitor an individual employee's input, Alchian and Demsetz claim, is the reason why many professional firms are employee-owned partnerships.

More recently, Eugene Kandel and Edward P. Lazear argue that peer pressure can produce higher effort among a firm's members.<sup>19</sup> Because firm members are more likely to apply pressure on other firm members to perform when they empathize with those whose income they affect – i.e. the firm's stakeholders – peer pressure is more likely to

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<sup>18</sup> Armen Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 Am. Econ. Rev. 777 (1972). Henry Hansmann argues that Alchian and Demsetz overstate the monitoring problem associated with professional work. He points out that professional firms go to great lengths to figure out how much each partner adds to the final product by, for example, tracking billable hours. In addition, he notes that most profit-sharing agreements reflect the individual productivity of each partner. HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* 70-71 (Harvard 1996). See also, Kevin Kordana [add cite] (making a similar argument). Others, however, have challenged Hansmann on this point, arguing that monitoring the work-product of professional service providers such as lawyers is not as easy as Hansmann suggests. See, e.g., David Wilkins & G. Mitu Gulati, *Reconceiving the Tournament of Lawyers: Tracking, Seeding, and Information Control in the Internal Labor Markets of Elite Law Firms*, 84 Va. L. Rev. 1581, 1598-99 (1998).

<sup>19</sup> Eugene Kandel & Edward P. Lazear, *Peer Pressure and Partnerships*, 100 (4) J. Political Economy 801, 805 (1992) (noting that, although peer pressure guarantees higher effort level, it does not guarantee higher utility, as peer pressure itself is a cost borne by the firm's members).

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be an effective motivating device in firms in which profits are shared among similarly situated individuals.<sup>20</sup> Accordingly, partnerships are more likely to produce higher peer pressure and induce higher effort levels, than are firms that are not organized for profit sharing.

As with the insurance justification for partnership, we accept the monitoring premise for the sake of analysis. Yet the choice of partnership form does not inevitably follow from this premise. In other words, as widely discussed in the worker cooperative literature, the monitoring explanation is an argument in favor of employee-ownership rather than investor-ownership of firms.<sup>21</sup> Nonetheless an employee-owned firm does not have to be a partnership. The close corporation and LLC are also typically employee-owned entities in which the residual claimants on profits are directly involved in management.<sup>22</sup> In any event, as with all profit-sharing based explanations, the monitoring story cannot fully explain the choice of organizational form in our sample. Because the profit-sharing characteristics of the GP and LLP are identical, considerations other than partner monitoring must explain the choice of organizational form.

## 2. Unlimited liability and monitoring

Another version of the monitoring argument asserts that unlimited liability encourages monitoring of each partner by every other partner. In the event of another partner's misstep, a partner does not want to be on the hook for a large payout. Accordingly, each partner pays close attention to the activities of her fellow partners. As a result, effort and care are maximized, and a better product results.

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<sup>20</sup> Kandel & Lazear, at 816.

<sup>21</sup> Add cites

<sup>22</sup> Check worker co-op literature – how are they typically formed? Hart & Moore?

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As discussed in Part III, however, this version of the monitoring explanation for partnership does not explain the choice of organizational form among the law firms in our sample. Because monitoring is presumably more difficult among firms with more lawyers and a higher number of geographically dispersed offices, we should observe significant differences in choice of organizational form based on these factors.<sup>23</sup> In fact, however, we do not observe such variation, undermining this version of the monitoring story.

### C. Generating Trust and Collegiality

A third explanation for the partnership form involves bonding and the creation of trust among partners. A partner, the theory goes, signals trust in her fellow partners by agreeing to personal liability for their actions. This trust creates a more congenial work environment, enhancing the quality of the product.

At first glance, the trust justification – because of its reliance on the unique unlimited liability characteristic of the GP form, rather than the profit-sharing explanation – seems a plausible explanation for the choice of GP form. However, as noted in the debate regarding the benefits of limited liability, the GP form is not the only mechanism for placing an owner’s personal wealth at stake in a business or professional enterprise.<sup>24</sup> In any event, the trust justification does not fully explain the data on choice of organizational form discussed in Part III of this Article. As more fully explained in Part

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<sup>23</sup> Kandel & Lazear at 812-13 (demonstrating that both the effectiveness and the incentive to monitor decrease with increases in firm size and geographic dispersion.)

<sup>24</sup> cites to LL debate. For example, the partners could form a limited liability entity, but personally guarantee debts. They could post personal bonds, or over-capitalize the corporation, rather than withdrawing funds in excess of that needed for working capital.

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III, there is no obvious reason why those firms opting to remain GPs place more value on trust than the LLP firms.

#### D. Quality Signaling

The signaling justification for partnership takes on two different forms, depending on the source of the signal. In the initial formulation, firms signal quality by adopting unlimited liability. In the more recent articulation, profit-sharing serves as the signal. The need for signaling arises because consumers are at an informational disadvantage and thus find it difficult to assess the quality of the product. As a result, they are reluctant to buy the product without some quality assurance.

##### 1. Unlimited Liability and Signaling

One version of the quality signaling argument asserts that unlimited liability encourages each partner to take more care in the provision of goods and services in order to avoid losing personal assets. In addition, as discussed above, unlimited liability is thought to encourage monitoring of each partner by every other partner. Knowing these facts, consumers feel more comfortable about the quality of the product. In other words, unlimited liability provides a credible signal of quality.

There are a number of problems with this argument. First, it does not explain the choice of organizational form among law firms in our sample. As elaborated in Part III, there is no obvious difference between the group of firms opting for LLP status and those choosing to remain partnerships that would indicate a greater need by firms in the GP group to signal quality. Second, although unlimited liability might serve as a signal, it is

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not the only possible signal of quality. For example, a firm can also signal quality by maintaining a good reputation, established through repeated interactions with consumers and word-of-mouth. For the unlimited liability story to work, one must demonstrate that unlimited liability is the cheapest credible signal of quality.

## 2. Profit-Sharing and Signaling

Jonathan Levin and Steve Tadelis advance a different signaling explanation for the partnership form, focusing on profit-sharing.<sup>25</sup> They start with the notion that an employee-owned firm engaged in profit-sharing is less inclined than a corporation to bring in new workers.<sup>26</sup> In a profit-sharing partnership, each partner cares about profit per partner, not total profits. As a result, a new partner will not be welcomed into the firm unless her additional profit is greater than the profits produced by the average partner. In contrast, a corporation, which cares about total profits, will bring in new workers if the marginal benefit of that worker is greater than the marginal cost. By focusing on the average instead of the marginal bump in profits, a profit-sharing partnership has an incentive to hire higher quality workers than the corporation.

Levin and Tadelis demonstrate, however, that this is not always an optimal result. If consumers know everything about the product, the partnership operates inefficiently. It hires too high a quality of worker and provides too high a quality of product. In the “full-information” market, consumers prefer to pay less and receive a lower quality product than the profit-sharing partnership produces. However, in markets where there are informational disparities, both the corporation and the partnership have an incentive to

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<sup>25</sup> Jonathan Levin and Steven Tadelis, *Profit-Sharing and the Role of Professional Partnerships*, Duke-UNC Micro-Theory Working Paper (November 2003).

<sup>26</sup> Benjamin Ward, *The Firm in Illyria: Market Syndicalism*, 48 AM. ECON. REV. 566 (1958).

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hire less able workers, hoping that the consumer won't notice the resulting loss in quality.

Levin and Tadelis thus conclude that the incentive to “cheat” on worker quality is mitigated in a partnership, because of the partnership's initial preference for higher quality workers. Levin and Tadelis argue that this explains why professional firms are more apt than other types of firms to organize as partnerships. The market for professional services – for example, law, medicine, or accounting – contains large informational disparities, making the choice of the partnership form efficient.

As with all of the profit-sharing based justifications for partnership, the Levin and Tadelis argument fails to explain the choice of organizational form among firms in our sample. As noted, there is no distinction between the GP and LLP forms in terms of profit sharing. In addition, neither partnership form is a necessary predicate for profit-sharing.

#### E. Preventing “Grabbing and Leaving”

According to the grab and leave justification for partnership, certain types of businesses – specifically, the practice of law – benefit from an up or out system of partnership.<sup>27</sup> This is because, over time, attorneys develop client-specific assets in the form of knowledge and expertise in the handling of specific clients. This expertise gives senior lawyers significant power over their employers. By threatening to “grab” their clients and leave the firm, these lawyers can extract a higher share of the firm's profits.

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<sup>27</sup> See, e.g., Ronald Gilson and Robert 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); James B. Rebitzer & Lowell J. Taylor, *When Knowledge is an Asset: Explaining the Organizational Structure of Large Law Firms* (working paper on file with author).

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To prevent this, law firms develop the up or out system of partnership in which associates are either fired before they get a chance to develop a relationship with clients or are promoted to residual claimants on the firm's assets.<sup>28</sup> This is more important in law firms than in conventional firms because law firms lack the ability to establish property rights in client-specific knowledge.

The partnership structure effectively eliminates the defection of partners, by maximizing profits per partner, rather than total profits.<sup>29</sup> According to Rabitzer and Taylor, only under the partnership structure can the senior attorneys be paid enough to prevent them from grabbing and leaving with the firm's clients, because the partnership structure results in higher profits per partner, even though the corporation results in higher total profits.<sup>30</sup>

The Rabitzer and Taylor theory, however, is not a convincing explanation for the choice of *any* partnership form, much less the GP form over the LLP. Like many economists, Rabitzer and Taylor assume that corporations are, by definition, entrepreneur-owned firms and that partnerships are, by definition, employee-owned firms.<sup>31</sup> Because employee owned firms are more profitable under certain circumstances that are important to professional firms, this explains the prevalence of the partnership structure among professional firms and the prevalence of the corporate structure among industrial firms.

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<sup>28</sup> The firm is unable to write enforceable contracts that prevent grabbing and leaving due to the ABA Model Rules, which prohibit contracts that limit a client's freedom to choose her lawyer. See, Rule 5.6 Model Rules; Hillman at \_\_\_.

<sup>29</sup> Rabitzer & Taylor at 10.

<sup>30</sup> Id. at 12. See also *infra* notes \_\_\_ and accompanying text (discussing this assumption in connection with the Levin and Tadelis theory).

<sup>31</sup> Rabitzer & Taylor at 12.

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However, neither corporations nor LLCs are necessarily entrepreneur-owned firms. In fact, it is quite common in close corporations and small LLCs to see a complete overlap of ownership and management, as is the case in a partnership. In any event, the grab and leave theory cannot explain the choice of organizational form among law firms in our sample, as both an LLP and GP would prevent grabbing and leaving equally well.

#### F. Incentives to Mentor

One of the most creative justifications for the partnership form involves mentoring.<sup>32</sup> The mentoring explanation begins from the premise that much professional work requires the development of human capital and many professionals require mentoring in order to enhance their skills. The junior associate, for instance, needs a senior partner to teach her how to conduct a trial or close a deal. As the professional ages, she has an incentive to hoard her knowledge and avoid mentoring new entrants to the profession. She would prefer to take her knowledge and leave the firm, keeping all of the benefits of her knowledge to herself. Partnerships, however, are relatively illiquid forms of investment, making exit difficult.<sup>33</sup> To maintain a pool of skilled workers to promote, the senior professional engages in mentoring. This mentoring is profitable because it increases the return on the partner's illiquid investment in the partnership.

Like all the other theories, mentoring is not a wholly satisfactory explanation for the existence of partnership and almost certainly fails to explain the GP form. Close

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<sup>32</sup> See Alan Morrison & William J. Wilhelm, Jr., *Partnership Firms, Reputation and Human Capital*, OFRC Working Paper Series (2003)

<sup>33</sup> According to Morrison and Wilhelm, only mentored – i.e. skilled -- workers accept promotion to partnership because the market eventually realizes whether a partner is skilled or unskilled. If promoted, the unskilled partner inevitably loses all her illiquid capital investment in the partnership, because the reputation of the firm will suffer. Accordingly, only skilled workers are willing to buy into the partnership. *Id.* at 3.

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corporations, LLCs and LLPs also represent relatively illiquid investments. In fact, such investments can be made just as illiquid as a partnership interest through the use of relatively routine restrictions on the transfer of interests. In addition, although the partnership default rules create an illiquid investment, as an empirical matter most partnership agreements have buyout provisions ameliorating this effect.<sup>34</sup> Finally, explanations based on illiquidity cannot explain the choice between GP and LLP, as there is no liquidity difference between the two types of forms. In fact, a firm that files for LLP status need not alter the underlying GP agreement, leaving any buyout provisions completely unaltered.

The following Part II of this Article explores an alternative explanation for the existence of the GP form – a penalty default explanation.

- II. The Partnership Penalty
- III. Empirical Results
- IV. The Anti-Competitive Effects of “Professionalism”
- V. Conclusion

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<sup>34</sup> See Ribstein, Corporations, *supra* note \_\_, at 12.