Committee Opinion
July 21, 1994

LEGAL ETHICS OPINION 1556

FEES-AGREEMENTS RESTRICTING PRACTICE: FEE DIVISION AND FINANCIAL DISINCENTIVE ARRANGEMENTS BETWEEN LAW FIRM AND LAWYERS WITHDRAWING TO PRACTICE IN COMPETITION WITH LAW FIRM.

Inquiry: The Committee is asked to opine generally with respect to provisions of employment/shareholder/partnership agreements (hereinafter referred to as "Agreements") between lawyers and a law firm whereby (i) withdrawing lawyers who take clients of the law firm and compete with it following their withdrawal are obligated to pay a certain portion of such clients' post-withdrawal fees to the law firm, (ii) the law firm is obligated to pay withdrawing lawyers some portion of fees received for their unbilled work or work in progress existing at the time of withdrawal, and (iii) financial disincentives are exacted from lawyers who withdraw from a law firm, with or without taking clients from the law firm, and practice in competition with the law firm.

Applicable Disciplinary Rules:

DR:2-105(D): A division of fees between lawyers who are not in the same firm may be made only if

(1) The client consents to the employment of additional counsel;

(2) Both attorneys expressly assume responsibility to the client; and

(3) The terms of the division of the fee are disclosed to the client and the client consents thereto.

DR:2-106(A): A lawyer shall not be a party to a partnership or employment agreement that restricts the right of a lawyer to practice law after the termination of a relationship created by the agreement, except as a condition to payment of retirement benefits.

Prior Relevant LEOs:

LEO #246: It is not permissible for law firms to have an employment agreement which prohibits an attorney from practicing in same geographical area as the firm for a specified period after termination of employment.

LEO #428: A provision in a partnership agreement among lawyers which tied a partner's right to receive termination compensation to a covenant against competition violated DR:2-106.

LEO #880: It is not permissible for a PC to implement an unqualified deferred compensation plan containing a restriction against attorneys practicing within a “reasonable radius” after withdrawal if the attorneys seek to obtain deferred compensation or interest on the investment of that attorney's compensation. Such a provision is permissible with respect to benefits under the plan which come from funding by the PC or third party.

LEO # 985: It is permissible for a PC to have an employment agreement with an attorney which provides for a reduction in the liquidation value of his stock if he (a) withdraws from the PC in concert with other attorneys and/or (b) carries clients of the PC with him. DR:2-106(A).

Opinion: I. Withdrawn Lawyer's Division of Fees with Former Firm for Post-withdrawal Services to Former Clients of the Firm. A lawyer who withdraws from a firm to compete with it and takes clients of the firm with him cannot be contractually obligated to divide his post-withdrawal fees from those clients with the firm. *See*, Texas Professional Ethics Committee, Op. No. 459, dated Oct. 7, 1988; Pennsylvania Committee on Legal Ethics & Professional Responsibility No. 87-105, dated Jan. 1988; and Illinois State Bar Association, Op. No. 86-16; dated May 13, 1987.

Clients electing to go with a lawyer withdrawing from a firm are no longer clients of the firm. The firm no longer renders legal services to them. The withdrawn lawyer alone renders legal services and, in turn, earns the fees. Hence, DR:2-105(D) ' s conditions precedent to a division of fees between the firm and the withdrawing lawyer cannot be satisfied. *See* LE Op. 1488. Under those circumstances client consent to a division of post-withdrawal fees would be unavailing since the firm from which the lawyer withdrew would not be *additional* counsel, and both the firm and the withdrawing lawyer would not render legal services to the clients accompanying him.

The rationale for the ethical proscription is well stated, as follows:

> [T]he interjection of a fee [to the firm from which the lawyer withdrew] obviously impairs the creation of a lawyer-client relationship between the departing lawyer and client of his former firm. The impairment arises on both sides of the transaction. The attorney may be unwilling to work at substantially reduced rates for even his best clients, and pressure against acceptance in favor of clients paying full value to the firm would arise within the new [firm employing the departing lawyer]. The attorney would thus be compelled to decline employment and the client would be deprived of the attorney of his choice . . . .

Texas Professional Ethics Committee, Opinion No. 459 at pp. 2-3.

II. Firm's Payment to Withdrawn Lawyer for Fees Received from Lawyer's Unbilled Work and Work in Progress at Time of Withdrawal. DR:2-105(D) speaks to a division of fees “between lawyers who are *not* in the same firm.” (emphasis added.) Though a lawyer who has withdrawn is no longer in the firm, his unbilled work and work in progress existing at the time of withdrawal were produced while he was in the firm. The fees attributable to such work, though received by the firm after his withdrawal, had been earned for services rendered as a member of the firm before his withdrawal.

Under those circumstances, neither the letter nor the spirit of DR:2-105(D) is violated by an Agreement which obligates the firm to make payment(s) to a withdrawn lawyer for fees received by the firm based upon the value of his unbilled work and work in progress at the time of withdrawal. *See*, Illinois State Bar Assoc., Op. No. 86-16 at p. 3:

> "With respect to the division of fees . . . . [F]ees earned while the associate was an employee of the firm are subject to division according with [*sic*] the terms of the employment agreement."

III. Financial Disincentives to Competition with Law Firm Following Lawyers' Withdrawal. A law firm's partners and associates form the nucleus of its income-producing assets. Thus, law firms often seek a buffer against the economic consequence of one or more of their lawyers withdrawing and practicing in competition with the firm — with or without taking clients with them.

Various financial disincentives have been fashioned in Agreements to protect the economic interest of the law firm. In each instance financial disincentives exhibit the inevitable friction between the practice of law as a profession, on the one hand, or as a business enterprise, on the other hand. *See Covenants Not to Compete and the Legal Profession*, 29 St. Louis Univ, L.J. 423, 438-446 (1985). The two recent cases which follow are paradigms of the competing philosophies.

Denburg v. Parker Chapin Flattan & Klimpl, 82 N.Y.2d 375, 662 N.E.2d 995, 605 N.Y.S.2d 900 (1993), addressed a provision of a partnership agreement, executed in 1983, that if a partner withdrew and entered private practice before July 1, 1988, he had to pay the law firm the greater of (i) 12.5% of the firm's profits allocated to him over the two previous years, or (ii) 12.5% of his billings to former clients of the firm over the ensuing two years. In addition, the agreement authorized the firm to apply the withdrawn partner's capital account to satisfy his payment obligation to the firm. A partner withdrew from the firm in 1984, and in 1986 the firm requested information about his billings to its former clients in order to determine his liability to the firm.

The New York Court of Appeals held that the provision was unenforceable as against the public policy expressed in DR 2-108(A) (adopted in Virginia as DR:2-106(A)).

> [R]estrictions on the practice of law, which include "financial disincentives" against competition as well as outright prohibitions, are objectionable primarily because they interfere with the client's choice of counsel: a clause that penalizes a competing attorney by requiring forfeiture of income could "functionally and realistically discourage" a withdrawing partner from serving clients who might wish to be represented by that lawyer . . .

* * *

> [W]e conclude that [the effect of the disincentive provision of the partnership agreement] is to improperly deter competition and thus impinge upon clients' choice of counsel. First, it applies only to lawyers continuing in private practice — and thus potentially in competition with the firm — but not other practitioners (for example, government lawyers) who do not threaten the firm's client base. Ability to pay cannot explain this discrimination because a departing partner becoming a high-paid corporate officer or embarking on a lucrative business venture is exempt from the required payment but an attorney starting a sole practice is not.
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> The provision, moreover, requires a departing partner to pay the greater of two amounts, one computed on the basis of billings to former clients of the firm. This bears little relation to the purported compensatory purpose of the clause and instead exacts an amount directly proportional to the success of a departing partner's competitive efforts . . . .

82 N.Y.2d at 380, 381.

The Supreme Court of California reached a diametrically opposed result in *Howard v. Babcock*, 6 Cal. 4th 409, 863 P.2d 150, 25 Cal. Rptr.2d 80 (1993). *Howard* addressed a provision in a law firm's partnership agreement that if more than one lawyer withdrew before age 65 and thereafter within a period of one year engaged in practice handling liability insurance defense work within a designated court system, such withdrawn lawyers were subject to a forfeiture of all of their withdrawal benefits except for their capital contribution.

The withdrawal benefits under the partnership agreement consisted of the capital account plus a sum equal to the withdrawn partners' shares of net profit that, but for withdrawal, would have been received during the twelve months immediately following withdrawal from the firm.

In December of 1986, four partners gave notice of their withdrawal to form their own firm effective January of 1987 and practice liability insurance defense work in the proscribed court system. Clients of the withdrawn partners' former firm substituted the withdrawn partners' firm. for their former firm in some 200 cases.

The withdrawn partners' former firm tendered payment of their capital account. It refused compensation to them for undistributed profits, accounts receivable for work billed but not paid, and work in progress to be billed in the future.

In a lengthy opinion, the California Supreme Court acknowledged but rejected the conventional wisdom of courts and commentators alike that the practice of law is a profession which is set apart from for-profit business enterprises. The rationale underlying validation of the disincentive agreement in *Howard* was stated, as follows:

> [A] revolution in the practice of law has occurred requiring economic interests of the law firm to be protected as they are in other business enterprises . . . .

* * *

> Withdrawing partners are able to announce their departure to clients of the firm, and many clients defect along with the attorneys with whom they have developed good working relationships. The practical fact is that when partners with a lucrative practice leave a law firm along with their clients, their departure from and competition with the firm can place a tremendous financial strain on the firm . . . .

* * *

> Recognizing these sweeping changes in the practice of law, we can see no legal justification for treating partners in law firms differently in this respect from partners in other business and professions.

6 Cal. 4th at 420, 421.

Turning to the Disciplinary Rules, the California Supreme Court addressed the substance of DR:2-106(A), as follows:

> We are not persuaded that this rule was intended to or should prohibit the type of agreement that is at issue here. An agreement that assesses a reasonable cost against a partner who chooses to compete with his or her former partners does not restrict the practice of law. Rather, it attaches an economic consequence to a departing partner's unrestricted choice to pursue a particular kind of practice.

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> The firm has a financial interest in the continued patronage of its clientele . . . . The firm's capital finances the development of a clientele and the support services and training necessary to satisfactorily represent the clientele . . . . In earlier times, this investment was fairly secure, because the continued loyalty of associates to the firm was assured. . . .

6 Cal. 4th at 419, 420.

Justice Kennard wrote a stinging dissent. His premise was that DR:2-106(A) sets forth an unwavering ethical standard.

> Although the law is a business in the sense that an attorney in a law firm earns a living by practicing law, it is also and foremost a profession, with all the responsibilities that word implies. The ethical rule that this court is called upon to interpret exists to enforce the traditional and sound view that service to clients,

> including protection of the clients' ability to employ the attorneys they have come to trust, is more important than safeguarding the economic interests of established attorneys and law firms. I would enforce the rule according to the ordinary meaning of its terms to bar all agreements by which established firms seek to protect themselves against competition from attorneys who leave the firm.
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> I cannot accept that the practice of law has been so altered that it is now irretrievably profit-centered rather than client-centered. If ethical rules for attorneys must accommodate the "realities" of practicing law, then those realities ought to include this court's insistence that attorneys serve more than their own interests and accomplish more than amassing fees. Protection of the public and preservation of public respect for the law require no less.
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> [I]n refusing to enforce a rule of ethics that prohibits attorneys from entering into agreements that restrict their right to practice law after leaving a firm, the majority diminishes the rights of clients in favor of the financial interest of law firms based on its one-sided view. of the realities and equities of the practice of law.

6 Cal. 4th at 427, 434.

The majority in *Howard* acknowledged, and the dissent reiterated, that upholding the disincentive covenant was contrary to the weight of authority. *See Ethical Pitfalls and Malpractice Consequences of Law Firm Breakups*, 61 Temple L. Rev. 1055, 1072-1075 (1988); ABA/BNA Lawyers' Manual on Professional Conduct 91:710-91:711. The majority suggested that the contrary decisions were inconsistent with reality and flawed by "lofty assertions about the uniqueness of the legal profession." 6 Cal. 4th at 423. *See Covenants Not to Compete and the Legal Profession, supra*.

Prior Virginia LEOs, excepting No. 985 in part, addressing the right of a lawyer to practice in competition with his former firm reflect the philosophy articulated in *Dansburg* and in the dissent in *Howard*. The inquiry in LE Op. 985 was whether it was permissible for a lawyer and a law firm, incorporated as a professional corporation, to have an agreement which provided for a reduction in the value of the stock of a withdrawn lawyer if he (a) withdrew in concert with other lawyers, *and/or* (b) took clients of the law firm with him.

The Committee concluded that the agreement did not violate DR:2-106(A), stating:

> The Committee opines that only those agreements that restrict the right of a lawyer to practice law *after* the termination of the relationship are prohibited [;] there is no prohibition on agreements that affect the termination of the relationship itself.

Significantly, the linchpin of the reduction in value of the stock was withdrawing from the law firm in concert with others *and/or taking clients of the law firm*. The agreement did not bar or by its terms restrict the withdrawn lawyer from practice in competition with the law firm, either generally or within a particular area for a specified period of time following his withdrawal, yet it exacted a financial penalty if law firm clients elected to go with the withdrawn lawyer.

The opinion expressed in LE Op. 985 is overbroad. Whatever the occasion for a law firm's break up, the clients' interests remain paramount. In LE Op. 1403, for example, the Committee concluded that a law firm's employment agreement prohibiting a withdrawn lawyer from contacting clients about his withdrawal until the firm had done so constituted a restrictive covenant in violation of DR:2-106(A), stating:

> The policy behind the ban on such restrictions is to protect the ability of clients to freely choose counsel and to protect the autonomy of that counsel. The agreement provision restricts the ability of the client [of the law firm] to make an informed and free choice of counsel.

See also LE Op. 1506.

The fundamental premises, though at times unspoken, are that clients of a law firm are not commodities, and that the law firm is not a merchant. If there is a break up of the firm initially chosen by a client, the client selects the lawyer or law firm to represent him thereafter. *Ethical Pitfalls and Malpractice Consequences of Law Firm Breakups, supra*, at 1064-65. A client's freedom to hire counsel of his choice transcends a law firm's interest in being protected against “unfair” competition. ABA/BNA *Lawyers' Manual on Professional Conduct* 51:1202.

Hence, LE Op. 985 is overruled to the extent that it approves a provision in an employment agreement permitting a law firm to exact a financial penalty from a lawyer (or lawyers) who withdraw and take clients of the law firm with them. Clients are not “taken;” they have an unfettered right to choose their lawyer. Correspondingly, lawyers withdrawing from a law firm have an unfettered right to represent clients who choose them rather than choose to remain with the law firm.

A recent request for an opinion presents a variation of the law firm agreement addressed in LE Op. 985. A law firm formed as a professional corporation (the “PC”) has an agreement which provides for periodic payments over three years to a Withdrawing Lawyer, defined as one who withdraws from the PC to retire, take a judicial appointment, or become employed with any entity not engaged in the practice of law in competition with the PC. If a lawyer withdraws to enter private practice and competes with the PC for clients within a fifty-mile radius during a period of three years following withdrawal, he is defined as a Competing Lawyer.

The PC agreement provides that if a Competing Lawyer represents any client originated by a Withdrawing Lawyer, the Competing Lawyer shall reimburse the PC for its payments to the Withdrawing Lawyer over the three years following the Competing Lawyer's withdrawal from the PC and practice within a fifty-mile radius in competition with the PC. The amount of the payments to a Withdrawing Lawyer is determined in large part by the fees which the Law Firm received from the clients originated by the Withdrawing Lawyer.

Since the Competing Lawyer's liability to the PC under the reimbursement formula is not fee-specific or based upon the quantum of fees received by him from clients originated by a Withdrawing Lawyer, the agreement is not an impermissible division of fees under DR:2-105(D). The Committee is of the opinion, however, that the agreement is violative of DR:2-106(A) as an impermissible restriction of the Competing Lawyer's right to practice law.

The agreement is essentially the obverse of the agreement found to be impermissible in LE Op. 428. There a withdrawn lawyer was denied termination compensation if he competed with his former firm. Here the Competing Lawyer incurs a liability to his former firm if he competes with it within a radius of fifty miles for a period of three years following his withdrawal. In each case, the withdrawn lawyer pays a financial price which is tied to his practice of law in competition with his former firm.

The Committee recognizes that the Competing Lawyer's liability to the PC is not measured by the amount of the fees which he receives from clients originated for the law firm by a Withdrawing Lawyer. Even so, liability to the law firm is inextricably tied to competition; a Competing, Lawyer is defined as one who "*competes for clients directly or indirectly within a geographic area within a radius of 50 miles from the Firm's primary business location*, at any time during a 3-year period commencing on the date of his or her departure from the Firm . . . ." (emphasis added.)

In short, the Competing Lawyer could compete for clients within a radius of 51 miles from the PC without liability because he would not fall within the definition of "Competing Lawyer." The financial disincentive is fashioned in order to give the PC a fifty-mile safe harbor from competition by Competing Lawyers for three years following their withdrawal. DR:2-106(A) does not permit any agreement that "restricts the right of a lawyer to practice law after the termination of a relationship created by the agreement, except as a condition to payment of retirement benefits."

Hence, the Committee is of the opinion that the agreement violates DR:2-106(A). *See Gray v. Martin*, 63 Or. App. 173, 663 P.2d 1285, *pet. for app. den*., 295 Or. 541, 668 P.2d 384 (1983); *compare Covenants Not to Compete and the Legal Profession*, *supra* at 437-38.

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