SOME PROBLEMS WITH MODEL RULE 5.6(a)

Stephen Gillers*

Elsewhere in this issue are citations to significant court decisions and ethics opinions addressing the meaning of Rule 5.6(a), whose ambiguous text provides that a "lawyer shall not participate in offering or making a partnership, shareholders, operating, employment, or other similar type of agreement that restricts the right of a lawyer to practice after termination of the relationship, except an agreement concerning benefits upon retirement."[1]

My remarks are not directed at an analysis of the authorities. Rather, after pointing out the text's lack of clarity, I want to address what policies the rule on post-departure compensation (payout) should reflect. That is, I want to imagine that there is no rule and that we are weighing what if any rule to adopt in our imaginary jurisdiction. Perhaps this exercise will facilitate reconsideration of the language of the current rule or its comment.

What Does the Rule Allow and Forbid?

Consider a common provision for determining the payment to a departing lawyer. That payment may encompass the lawyer's capital account (or its equivalent if the firm is not organized as a partnership). The capital account is the lawyer's interest in the assets of the firm (equipment, furniture, and the like) and is likely to be modest. The payout will also provide a formula for determining the lawyer's interest in work in progress (work done but not yet billed) and accounts receivables (work billed but not yet paid for). I am going to assume that all departing lawyers receive their capital account and will say no more about it. But whether they receive their formulaic share of work in progress and accounts receivable (hereafter collectively "WIP/AR or "payout") is contingent under alternate provisions described below. The question is: what may those contingencies be under the current rule? Let's examine the language of the rule.

a. "restricts the right of a lawyer to practice":

What counts as a *restriction* on the right to practice? This and *retirement* are indeed the key concepts under the Rule but the meaning of neither is self-evident. Does restriction include *any* direct prohibition, however circumscribed in space and time, practice area, or client? Probably, as courts and committees have construed the language, the answer to this question is yes. If the lawyer may not practice even in a limited area for a brief time or may not serve an identified client, her practice is directly restricted.

What then about indirect restrictions? Do they count? For example, can an agreement grant WIP/AR only to those who enter government service? Only to those who work in public interest jobs? To those who teach? A no answer would rest on the claim that if the

* Professor, New York University School of Law.

[1] *See* Ronald C. Minkoff, Compilation of Cases Involving Restrictive Covenants Among Law Partners (MR 5.6/DR 2-108), SYMPOSIUM ISSUE OF THE PROFESSIONAL LAWYER (2007).

agreement treats lawyers in each of these practice settings more favorably than it does, say, lawyers who move to a law firm, it creates a disincentive to private practice in a firm setting, and so a restriction within the meaning of the rule. Looked at this way, the Rule in effect is a guarantee of equal treatment for lawyers who stay in private practice.

How about a limitation based not on the nature of post-departure employment—the departing lawyer may work at whatever she likes—but income. The amount of the departing lawyer's payout will be decreased if her income exceeds a stated sum. For example, the agreement might say that the full payout (determined according to a formula) will be reduced one dollar for every two dollars the lawyer earns from employment in excess of $150,000 yearly. That agreement assures compensation to those entering public service or public interest careers and also to lawyers who stay in private practice but earn less than the limit (for example, in a start-up firm). But the agreement would deny a payout to those who earn the same high income in another (competitive) law firm as well as to those who earn a high income in noncompetitive endeavors (*e.g.*, in an investment bank or a general counsel's office).

Should we view this provision as a restriction on practice on the theory that the effect, if not the neutral language, is to treat lawyers remaining in high paying competitive private practice unequally? Or should we view such a provision as "competition neutral," as one arbitrator did (and whose award was enforced by the court)?

Another indirect restriction may reduce the size of the payout depending on the lost income to the firm as a result of the loss of clients that the departing lawyer takes with her. The lawyer is free to take those clients, of course, but the agreement contains a formula for projecting the income the firm will lose (based on past fees from the lost clients) and adjusts payout accordingly. While this may make economic sense for a firm that was relying on fees from the lost clients to fund the payout, it may be seen to deter the departing lawyer from taking the clients and therefore operate as an indirect restriction on practice.

Alternatively, a firm may say that because all new partners begin to participate in WIP/AR immediately on becoming partners even though they did not generate any of the income (*i.e.*, they enjoy "frontload" participation in firm profits), the firm deserves a credit against the amount of the payout following departure. That credit might be the amount of this frontloaded participation with interest or adjusted to present value. If the firm cannot do this, it might choose to deny its new partners any participation in WIP/AR until they begin to contribute to firm profit. Aside from the bookkeeping nightmare that would entail, it penalizes those partners who stay at the firm until retirement. Would a firm that insisted on a credit for frontloaded participation violate the rule? Or would it simply be asking for its money back?

Or consider what might be the most indirect restriction of all: The firm agreement says that no departing lawyer gets any payout regardless of what he or she may do thereafter, excepting only lawyers who retire and promise not to compete (the exception the rule envisions). Here, no partner is treated unequally. Is that agreement forbidden? Perhaps so, if we read the rule to require a payout to everyone on the theory that lawyers will otherwise be inhibited from leaving, even when they can better serve their clients or develop professionally elsewhere. The language of the rule could actually be read (wrongly in my view) to *mandate* a payout.

b. "benefits upon retirement":

The rule's exception allows benefits upon retirement to be conditioned on a restriction on law practice. Imagine an agreement that says only lawyers who retire get a share of WIP/AR. So far so good. But what does retirement mean? Obviously, firms cannot define retirement as an agreement not to compete (or an agreement otherwise to restrict law practice) because that would nullify the rule. Retirement must have a reference outside the language of the rule. It must include age or years of service (or more likely some combination of the two) because that is how retirement is conventionally understood. That's the easy part. The hard part is to identify what restrictions a firm must impose on a retiring lawyer. To see why this is hard, consider the following conditions in a retirement provision.

Condition A: The retiring lawyer must cease all gainful employment whether as a lawyer or otherwise. Surely, that condition fits a conventional understanding of retirement and would fall within the exception. No more need be said about it.

Condition B: The retiring lawyer must not thereafter earn an income from law practice.

Condition C: The retiring partner may do whatever work she wishes, including as a lawyer, but must not practice within a defined geographical area or work for current clients.

Condition D: The retiring partner may do any work with no restriction at all.

Intuitively, we might be inclined to ask why, if the firm can impose condition A (no gainful employment whatsoever), it could not impose a lesser restriction so long as the departing partner satisfies an objective standard for what retirement means, which we assume she does. The answer is that if the firm opens the door a little—and certainly if it opens the door a lot—it may fear a challenge to its claim that the retirement clause falls within the rule's exception. An example will make this clear.

At the partnership meeting called to discuss the language of the firm's retirement clause, partner Easy argues against a total (or indeed any) ban on gainful employment after retirement. Partner Worrier poses this hypothetical. Jones, age 64, leaves his firm in Chicago after 35 years and relocates to Tucson, where his daughter is a lawyer. She asks him to help out a day a week (or maybe even full time) because Jones has a specialty her firm can use. Jones will be paid. Should the law firm's agreement allow Jones to perform the work? How should the partnership decide?

ABA Opinion 06-444, which sensibly adopts an objective test for the meaning of retirement, explicitly permits a firm to adopt conditions B or C without undermining the validity of its retirement provision. But that's the ADA's interpretation of its rule and not an inevitable one. A state court may choose differently. If there is no final precedent in the relevant jurisdiction, the firm will have to predict what the court may do at its peril. Indeed, the firm will sometimes have to predict which jurisdiction's rule will control. The jurisdiction in which Jones practiced? The jurisdiction of the firm's main office if different? The place to which Jones has moved and is working? Can the answer be determined by the firm's governing documents? We don't know.

The firm may not care what Jones does—most likely his partners are happy that he can remain active—but it may worry that if it gives Jones his payout without requiring him to cease all work, a second partner, Smith, who departs (or has already departed) for competitive practice, will claim a payout, too. If the firm has adopted any of the conditions above (except A), Smith will argue that Jones has not been required to retire at all. He's allowed to earn money by working, the very opposite of retirement, which makes the retirement provision a sham. (Smith may argue that the Rule's exception requires "retirement," not "retirement from the firm.") If the firm has adopted conditions B or C—permitting work but forbidding competitive practice—Smith will make the additional argument that the firm is using the rule's exception as a subterfuge to treat lawyers who leave to compete unequally.

What Interests Should a Sensible Rule Reflect?

Let's start by identifying the legitimate interests. The firm's interests first:

a. The firm (and here I include of course the lawyers at the firm) has an interest in its economic security. A departing lawyer may take so much business that the loss of it will cause serious harm to that security. Sometimes, several lawyers or even whole departments of a firm leave, creating serious financial threats.
b. The firm and its lawyers, who are mature economic actors, have an interest in being able to reconcile the competing considerations in advance through agreement and without undue state interference. Remember, the departing lawyer who seeks to invalidate a payout provision will, at some point, have agreed to that provision. He or she may even have advocated for it and benefited from it if, as will often be so, the provision has reduced or eliminated the payout for lawyers who departed during the lawyer's tenure at the firm. True, young partners may have no real bargaining power on this issue but that's dilemma many young professionals and executives face.

Now the interests of the lawyer who wishes to depart:

c. Lawyers have a legitimate interest in being able to change practice settings without significant economic loss.
d. Clients have an interest in their lawyers being able and willing to change practice settings to one in which the lawyers believe they can better serve the clients without having to suffer an undue financial penalty.

Today, at least facially, the rule recognizes the interests of departing lawyers to the near exclusion of the legitimate interests of the firm. Or to put it another way, the rule puts a law firm that wants to protect its economic security—a reasonable goal—in the unpleasant position of having to deny a payout to all non-retiring departing lawyers regardless of the lawyer's new job. The firm is forced to say to the lawyer who (for example) departs for public service:

> "We respect your sacrifice and would like to give you a payout but unfortunately we expect that if we do, other lawyers who leave (or those who have already left) for lucrative partnerships elsewhere, and who may take (or have taken) good clients, will be able to cite our generosity to you to get money that we won't be able to afford. So we're both held hostage by the state rule. We don't like it either, but we have no choice."

This makes no sense. Why should lawyers be granted an immunity from restrictive covenants that is denied other professionals and executives?

What Should a Sensible Rule Say?

Of course, not all permutations are possible to predict so a sensible rule has to include a standard along with some bright lines. A rule could, for example, contain a prohibition against "unreasonably restricting" a departing lawyer's practice as a condition of payout. The comment could identify the legitimate interests to be weighed in evaluating the reasonableness of an agreement's restriction. Over time, court decisions and ethics opinions will provide greater detail.

But the rule could also state that an agreement that prohibited a lawyer from practicing in a particular geographic area or in a particular practice setting or that prohibited the lawyer from accepting work for certain clients (no matter how limited in time or nature of the work) would be per se unreasonable.

Conversely, the rule could contain safe harbors. An agreement that calibrated payout to take account of post-departure income, however earned, would be presumptively acceptable. So would a provision that allowed payout only to those lawyers entering government or public service. Other examples are surely possible.

Finally, the rule could provide that a firm is free to impose limited restrictions or even no restrictions on post-departure income (or the source of the income) as a condition of payout on retirement as conventionally understood. The firm does not have to forbid all income or all income from law practice in order to come within the exception.

The problem is that right now we have a categorical prohibition, which, like all categorical prohibitions, will inevitably ignore other legitimate interests without corresponding advantages. The results work unfairness and unnecessarily interfere with informed economic choices for no valid reason.