

## **CALIFORNIA ETHICAL RULES GOVERNING RESTRICTION ON LAW PRACTICE**

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California has not adopted any of the ABA Model Rules, although a special commission is currently drafting new rules patterned upon them. California has a unique set of disciplinary rules, some of which differ in material respects from the Model Rules. California's equivalent to Model Rule 5.6 is California Rule of Professional Conduct 1-500, which provides:

(A) A member shall not be a party to or participate in offering or making an agreement, whether in connection with the settlement of a lawsuit or otherwise, if the agreement restricts the right of a member to practice law, except that this rule shall not prohibit such an agreement which:

(1) Is a part of an employment, shareholders', or partnership agreement among members provided the restrictive agreement does not survive the termination of the employment, shareholder, or partnership relationship; or

(2) Requires payments to a member upon the member's retirement from the practice of law; or

(3) Is authorized by Business and professions Code sections 6092.5 subdivision (i), or 6093.

(B) A member shall not be a party to or participate in offering or making an agreement which precludes the reporting of a violation of these rules.

In the Discussion section that is included immediately following the text of Rule 1-500, the following appears:

Paragraph (A) permits a restrictive covenant in a law corporation, partnership, or employment agreement. The law corporation shareholder, partner, or associate may agree not to have a separate practice during the

existence of the relationship; however, upon termination of the relationship (whether voluntary or involuntary), the member is free to practice law without any contractual restriction except in the case of retirement from the active practice of law.

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In 1993, the California Supreme Court issued a decision in *Howard v. Babcock*,<sup>1</sup> reversing a ruling of the Court of Appeal, to the effect that Rule 1-500 was violated by a partnership agreement provision that required withdrawing partners to forego contractual financial benefits in the event that the former partners competed with their former law firm. The restrictive covenant allowed the remaining partners, at their sole discretion, to cause forfeiture of all of the withdrawing partner's rights to withdraw benefits other than capital, in the event that the withdrawing partner withdrew prior to age 65 and within one year thereafter, engaged in liability insurance defense work within certain Southern California counties.

The majority decision noted that "California has a settled policy in favor of open competition." Pursuant to California Bus. & Prof. Code § 16602, any partner may agree that he or she will not engage in a similar business within a specified geographic area, in which prior partnership business has been transacted. The majority noted that the statute had been used to enforce covenants not to compete among partners in many professions, including accountants and physicians.

The Supreme Court noted that there was then a dispute among the appellate courts, and that (contrary to the lower court in *Howard v. Babcock*) another appellate court, in *Haight Brown & Bonesteel v. Superior Court*<sup>2</sup> had found that Business & Professions Code § 16602 took precedence over Rule 1-500 of the Rules of Professional Conduct, and held that restrictive covenants are permissible among partners and law firms.

The *Howard v. Babcock* Court went on to note that only those agreements between partners in restraint of competition that place a reasonable price on competition will be upheld. The common law "rule of reason" was applied to ensure that the competing former partner shall pay only fair compensation for the loss that may be sustained by the former partnership as a result of the departing attorney's competition.

The California State Bar, as amicus curiae, urged the *Howard v. Babcock* court to rule that Rule 1-500 required a higher standard to be applied to partners in law firms. In rejecting the State Bar's approach, while observing that Rule 1-500 was based on ABA Model Rule 5.6, the Supreme Court stated:

"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."<sup>3</sup>

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<sup>1</sup> *Howard v. Babcock*, 6 Cal. 4th 409, 25 Cal.Rptr. 2d 80 (1993).

<sup>2</sup> *Haight Brown & Bonesteel v. Superior Court*, 234 Cal.App. 3d 963, 969, 289 Cal.Rptr. 845 (1991).

<sup>3</sup> *Howard*, 6 Cal.4th at 419.

The majority also cited with approval from the decision of the appellate court in *Haight Brown & Bonesteel v. Superior Court*,<sup>4</sup> as follows:

“We do not construe Rule 1-500 in such a narrow fashion. . . . The rule does not . . . prohibit a withdrawing partner from agreeing to compensate his former partners in the event he chooses to represent clients previously represented by the firm from which he has withdrawn. Such a construction represents a balance between competing interests. On the one hand, it enables the departing attorney to withdraw from a partnership and continue to practice law anywhere in the State, and to be able to accept employment should he choose to do so from any client who desires to retain him. On the other hand, the remaining partners remain able to preserve the stability of the law firm by making available the withdrawing partner’s share of capital and accounts receivable to replace the loss of the stream of income from the clients taken by the withdrawing partner to support the partnership’s debts.”

*Howard v. Babcock* went on to reject the view adopted in other states, that clients have unfettered ability to choose counsel of their choice and that attorneys must be completely free to choose when, where and for whom to practice law. The Supreme Court stated:

“Upon reflection, we have determined that these courts’ steadfast concern to assure the theoretical freedom of each lawyer to choose whom to represent and what kind of work to undertake, and the theoretical freedom of any client to select his or her attorney of choice is inconsistent with the reality that both freedoms are actually circumscribed. Putting aside lofty assertions about the uniqueness of the legal profession, the reality is that the attorney, like any other professional, has no right to enter into employment or partnership in any particular firm, and sometimes may be discharged or forced out by his or her partners even if the client wishes otherwise. Nor does the attorney have the duty to take any client who proffers employment, and there are many grounds justifying an attorney’s decision to terminate the attorney-client relationship over the client’s objection. [Citation omitted]. Further, an attorney may be required to decline a potential client’s offer of employment despite the client’s desire to employ the attorney. For example, the attorney may have a technical conflict of interest because another attorney in the firm previously represented an adverse party. [Citations omitted.] Finally, the client in the civil context, of course, ordinarily has no “right” to any attorney’s services, and only receives those services he or she can afford.”

The majority also pointed out that contemporary changes in the legal profession, such as attorney advertising, reflect the fact that the habits of commerce have permeated the legal profession.

The lone dissenter, Justice Kennard, noted with alarm that the trial court that upheld the restrictive covenant, directed the plaintiffs/former partners to pay the law firm 82.5% of the profits derived from work plaintiffs performed *after* the termination of the partnership. The dissent found that covenants not to compete restrict the practice of law in clear violation of the

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<sup>4</sup> *Haight* 234 Cal.App. 3d 963 at pp. 969-970.

plain meaning of Rule 1-500, stating:

“To enforce covenants not to compete is to exalt the economic interest of established law firms while necessarily disfavoring the rights of clients, especially the right to an attorney of one’s choice.”

Notwithstanding the strong dissent expressed by Justice Kennard, *Howard v. Babcock* has never been overruled, and California seems unlikely to revisit the California Supreme Court’s interpretation of Rule 1-500.

In addition to reliance upon California Rule of Professional Conduct 1-500, California courts have used other rules of professional conduct in an effort to avoid restrictive covenants on legal practice. In *Anderson McPharlin, et al. v. Yee*,<sup>5</sup> upon joining a partnership, a lawyer signed a partnership agreement in which he agreed to make payments to the firm according to a set formula, if he left the firm and took clients with him. The departing partner subsequently left the firm, taking more than two dozen clients with him. In an effort to avoid making payments to the firm pursuant to the partnership agreement, he claimed that the rules prohibiting fee splitting arrangements among lawyers without the informed written consent of the client prohibited him from paying any portion of attorneys’ fees to his prior firm. In rejecting these arguments, the California Appellate Court ruled that by its plain language, Rule 2-200 (A), governing division of fee arrangements, did not apply to partners. Additionally, the court found that the contractual requirements to compensate the partnership for money spent to generate the business that resulted in the fees paid to the departing partner, was neither ethically prohibited nor an unlawful forfeiture. Interestingly, Rule 1-500 is not relied upon by the court.

In *Dickson\Carlson & Campillo v. Pole*,<sup>6</sup> in the second of two civil actions, plaintiffs, the remaining partners of a law firm, sued the departing partners and their new firm, following the departing partners’ having withdrawn from the law partnership, taking the firm’s largest client with them. The plaintiffs sought to recover tort and contract damages arising from the departing partners’ alleged misconduct, including their share of profits from the defendant’s completion of the partnership’s unfinished business, and also damages arising from the loss of future business. The defendants had succeeded in persuading the trial court that the plaintiffs had a fiduciary duty to complete some of the unfinished business, and had failed to do so, thereby forfeiting their claims under the equitable maxim, “one who seeks equity must do equity.” However, the Appellate Court found that the trial court had erred by failing to quantify the damages caused by plaintiffs’ alleged inequitable conduct, and the matter was remanded to the trial court for consideration of the relative equities of the parties and an allocation of damages. By its decision, the Appellate Court clearly intended that the remaining partners of the original law firm be at least partially compensated for the business lost to the departing partners.

Finally, in *Reeves v. Hanlon*,<sup>7</sup> the owner of a law firm sued departing associates, after he arrived at the law office one morning to find the associates and other key employees gone, together with confidential client lists and client files. Although the departing associates had not

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<sup>5</sup> *Anderson McPharlin, et al. v. Yee*, 135 Cal. App 4th 129, 37 Cal. Rptr. 3d 627 (2005).

<sup>6</sup> *Dickson\Carlson & Campillo v. Pole*, 83 Cal.App. 4th 436, 99 Cal. Rptr. 2d 678 (2000).

<sup>7</sup> *Reeves v. Hanlon*, 33 Cal.4th 1140, 17 Cal.Rptr.3d 289 (2004).

signed a restrictive covenant, the California Supreme Court found that the employees could be liable under an intentional interference theory, for having induced at-will employees to terminate their employment. The Supreme Court noted that the departing associates engaged in unlawful and unethical conduct, in mounting a campaign to deliberately disrupt the law firm's business, and that the misappropriation of the employing lawyer's confidential client list constituted a violation of the California Uniform Trade Secrets Act.<sup>8</sup>

Thus, in California, departing partners will be bound by reasonable restrictions on future competitive practices, within the rule of reason. Additionally, even if the departing attorneys have not signed an agreement that includes restrictive covenants on future practice, relief based on other legal theories may be sought in the event that the departing attorneys engage in conduct constituting interference with existing or prospective business opportunities, misappropriation of trade secrets, interference with employment of other law firm employees, and violation of duties to complete unfinished partnership business.

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<sup>8</sup> California Civil Code §3426.