ETHICAL RULES, LAW FIRM STRUCTURE, AND CHOICE OF LAW

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ABSTRACT

State regulation of lawyers has failed to keep pace with the increased complexity and geographic scope of law practice. A particular problem is that lawyers in the branch office of a multi-jurisdictional firm are subject to the ethical rules of the state in which the branch office is located. The firm therefore potentially is subject to differing regulations in each state where it has branches. This is particularly a problem concerning rules that apply to the firm as such, including rules regarding the firm's name and capital structure. As a result, firms must either accept uniform rules or the rules of the most restrictive state. This means that structural rules do not accommodate the many differences among firms as to size, structure, market, and other factors. It also produces a single rule from a flawed political process rather than allowing for competition or evolution of rules. If left free of constraints, law firms would seek to maximize the market value of their assets, particularly including reputational assets, including by finding ways to motivate the firm's members to devote efforts to serving its clients. Thus, forcing firms to comply with uniform or restrictive state ethical rules relating to such matters as capital structure and non-competition agreements may perversely hurt the very clients such rules are supposed to protect. This article proposes solving this problem by permitting law firms to agree to application of a single state's ethical rules that relate to law firm structure. This would offer the advantages of an "internal affairs" choice-of-law rule for non-professional firms.

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As law practice increases in complexity and geographic scope, state regulation of lawyers has not kept pace. Commentary has focused on the questions individual lawyers face when they travel around the country to advise or represent clients, appear virtually in other jurisdictions through phone, fax or Internet, or work in multiple offices of large, organizational clients.[1] Although there are many questions concerning whether a lawyer may be deemed to be practicing law in a state in which she is not licensed,[2] and about what law applies to lawyers who practice in multiple jurisdictions,[3] lawyers *based in* the branch office of a multi-jurisdictional firm clearly are subject to regulation in the state where the branch is located. This means that the firm potentially must comply with differing regulations in each state where it has branches. This is particularly a problem concerning rules that apply to the firm as such, including rules regarding the firm's name and capital structure.[4]

Applying multiple state regulations to multi-jurisdictional law firms may not seem to present as serious a problem as regulating individual lawyers because the firm itself does not have to obtain a license in each state. Rather, lawyer regulation is commonly regarded as aimed at individual lawyers rather than the firms in which they practice.[5] Firms can solve the problem of multiple state rules simply by complying with the rules of the most restrictive state except in the rare situation where the rules impose conflicting obligations, such as with respect to rules concerning disclosure and confidentiality. Uniform rules promulgated by the American Bar Association[6] provide an alternative

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[1] *See, e.g.,* SYMPOSIUM ON THE MULTI-JURISDICTIONAL PRACTICE OF LAW, Fordham University School of Law, March 10-11, 2000, available at http://www.abanet.org/cpr/mjp-march_articles.html.

[2] *See, e.g.,* Charles W. Wolfram, *Sneaking Around in the Legal Profession: Interjurisdictional Unauthorized Practice by Transactional Lawyers*, 36 S. TEX. L. REV. 666 (1995).

[3] *See, e.g.*, Jeffrey L. Rensberger, *Jurisdiction, Choice of Law, and the Multistate Attorney*, 36 S. TEX. L. REV. 799 (1995).

[4] For example, Wolfram notes the problems multi-state law firms have regarding rules governing use of non-locally admitted lawyers' names, fee splitting with non-lawyers and non-lawyer ownership. *See* Charles W. Wolfram, MODERN LEGAL ETHICS §15.4 (1986).

[5] 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, 203-04 (2000) (noting that the Ethics 2000 Final Report "continues the historic tradition of directly regulating only individual lawyers").

[6] *See generally*, MODEL RULES OF PROFESSIONAL CONDUCT. The Ethics 2000 Commission has proposed a revision of these rules. *See* Ethics 2000 Commission on the Evaluation of the

solution to the problem that does not involve a single major state's imposing its restrictive rule nationwide.

The problem with applying ethical rules to multi-jurisdictional law firms based on the location of their branch offices is not that the system is unworkable but that it is inefficient. Forcing the firm to accept uniform rules or the rules of the most restrictive state means that structural rules do not accommodate the many differences among firms as to size, structure, market, and other factors. It also means that rules are produced by a flawed political process rather than by competition or evolution. The current regulatory system may actually increase hurt clients by interfering with law firms' ability to develop incentive structures that ensure high quality service.[7] Law firms, like other types of firms, will seek to maximize the market value of their assets, particularly including reputational assets, including by finding ways to motivate the firm's members to devote efforts to building the firm's reputation.[8] Forcing firms to comply with uniform or restrictive state ethical rules relating to such matters as capital structure and non-competition agreements may frustrate these efforts.

Regulation of multi-disciplinary firms illustrates the perverse effect of the current regulatory system. Although convergence and synergy dominate business models in every industry and have begun to penetrate professional services, states continue to insist that lawyers practice in law-only firms. Reform has stalled despite extensive commentary favoring the development of these firms and strong trends and competitive forces indicating that such firms are inevitable. Even if a state is willing to innovate, its rule has little effect unless it is enforced in all of the states in which the firm has branches. States therefore cannot hope to attract national firms by adopting innovative rules. Reform through the ABA's uniform lawmaking process is subject to a laborious process of political compromise and to effective veto by the most intransigent regulators.

This article proposes solving this problem by applying ethical rules that relate to law firm structure on a firm-wide, rather than lawyer-by-lawyer, basis. A system that lets firms choose the applicable rules would be efficient for reasons similar to those that justify an "internal affairs" choice-of-law rule for non-professional firms. There is precedent for this approach in the structural rules that apply to professional firms through business organization statutes, such as those for professional corporations, limited liability companies (LLCs) and limited liability partnerships (LLPs). In particular, limited liability is now widely applied to firms based on the state of organization.

Part I of the article shows why firm-based regulation is necessary with respect to a specific category of "structural" ethical rules. These rules all relate directly to the division of governance and financial rights within the firm. Thus, a firm that has integrated branch offices must comply with structural rules imposed in any state where a branch is located.

Part II shows why firms should have some ability to choose the applicable regime rather than having it imposed by a single branch-office state or by a central rulemaking body. This argument is based on the benefits of competition, variation and evolution of

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Rules of Professional Conduct, November, 2000, available at www.abanet.org/cpr/ethics2k.html.

[7] *See* Larry E. Ribstein, *Ethical Rules, Agency Costs and Law Firm Structure*, 84 VA. L. REV. 1707 (1998).

[8] For an explanation of law firms in terms of reputational bonding, *see id*. *See also* Fredrik Andersson, *The Firm as a Pool of Reputations*, Lund University Department of Economics Document, http://papers.ssrn.com/paper.taf?abstract_id=115011 (August 1998).

legal rules. This Part also shows why the danger of a "race to the bottom" in ethical rules is minimal.

Part III considers how choice of law for law firms might arise within the current system. Given the bar's strong interest and influence in maintaining the regulatory status quo, it might seem that Congressional action is necessary to break the regulatory roadblock. Yet such an approach carries its own political peril and overlooks uncertainty about the specific content of choice-of-law rules. Moreover, a system of firm-wide ethical rules may evolve through a combination of market and political pressure.

Part IV discusses implications of this analysis of firm-wide structural ethical rules. Arguments for giving firms some power to choose the applicable law may also apply to individual lawyers and to non-structural rules.

Part V contains concluding remarks.

I. STRUCTURAL ETHICAL RULES AND MULTI-JURISDICTIONAL FIRMS

This Part shows how certain types of ethical rules affect firm structure. It follows that these rules should be applied to *firms* rather than to individual lawyers. Part II discusses the appropriate mechanism for this application – that is, ex ante choice of regulatory regime rather than a strictly territorial approach or uniformity.

The discussion in this Part assumes that a single "firm" has branch offices in several states. This means essentially that partners based in all of the branch offices are co-owners of the national firm rather than only of a distinct firm based in a particular state. This assumption raises the initial question whether the office in which the lawyer is practicing is integrated into a larger firm or only contractually affiliated with it. Integration probably will turn generally on whether lawyers are sharing profits in, and the right to control, the firm as a whole rather than only the branch.

Use of contractual affiliate structures might avoid the problems discussed in this article but would raise additional problems because they are not necessarily fungible with integrated structures. In order to have the advantages of a multi-state law firm, the branch offices would have to share a common reputation, similar to retail outlets that share brand identification. The contractual arrangement must be designed to give lawyers in the branch adequate incentives to maintain the overall brand name rather than free-riding off the brand name by cutting costs locally. At the same time, the contracts must be designed to minimize monitoring costs that will tend to rise when the high-powered incentives of local ownership are replaced with the lower powered incentives of being a part of a large organization. As has been shown in the analogous franchise context, the right contractual mix for each firm may depend on a variety of factors, including whether the branch's clients are mostly national or partly local, which helps determine the extent to which product markets discipline shirking at the branch level.[9] A firm's decision to contract

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[9] *See generally,* Benjamin Klein, *Transactions Costs Determinants of "Unfair" Contractual Arrangements*, 70 AM. ECON. REV. PAPERS & PROC. 356 (1980), Benjamin Klein and Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981), Patrick J. Kaufmann & Francine Lafontaine, *Costs of Control: The Source of Economic Rents for McDonald's Franchisees*, 37 J. L. & ECON. 417 (1994), Francine Lafontaine, *Agency Theory and Franchising: Some Empirical Results*, 23 RAND J. ECON. 263 (1992) and *Contractual Arrangements as Signalling Devices: Evidence from Franchising*, 9 J. L. ECON. & ORG. 256 (1993); Benjamin Klein, *The Economics of Franchise Contracts,* 2 J. CORP. FIN. 9 (1997); Francine Lafontaine and Sugato

with local outlets or have integrated branch offices therefore has economic consequences apart from regulation.

An *individual lawyer* can practice legally in a branch of an integrated multi-state firm in accordance with local rules even if she is also a member of a state bar with whose rules the firm does not comply *but only if* the lawyer is not based in the more restrictive state.[10] Thus, the *firm* is subject to the rules of each state in which its individual lawyers are based. This is a problem because each state's "structural" rules, which are described in this Part, all directly affect the overall organization of the firm, even if they are imposed only at the branch level. These effects apply to several kinds of ethical rules:

- Rules mandating some form of vicarious liability affect all of the lawyers in the integrated firm.

- Regulation of the firm's capital structure – that is, restricting who can own shares in the firm – obviously applies throughout the integrated firm.

- Restrictions on non-competition agreements indirectly bear on compensation of, and allocation of property rights among, all of the firm's members.

- Rules imputing client conflicts of interest between the firm and individual lawyers affect the firm's size and require firm-level screening structures.

- Rules concerning promotion and advertising of the firm affect the entire firm's ability to build reputational capital.

- Rules requiring the firm to monitor its members' ethical compliance effectively create firm-wide implications for all ethical rules.[11]

In general, to the extent that structural ethical rules applied at one node affect entire multi-jurisdictional firms, state ethical rules can impose spillover costs on other jurisdictions by preventing some firms from adopting what would otherwise be optimal branching into restrictive jurisdictions without at the same time adopting suboptimal

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Bhattacharyya, *The Role of Risk in Franchising,* 2 J. CORP. FIN. 39 (1997); Seth Norton, *Is Franchsing a Capital Structure Issue*, 2 J. CORP. FIN. 75 (1997); Nancy Lutz, Ownership Rights and Incentives in Franchising, 2 J. CORP. FIN. 103 (1997); Steven C. Michael and Hollie J. Moore, *Returns to Franchising* 2 J. CORP. FIN. 133 (1997); J. Howard Beales III & Timothy J. Muris, *The Foundations of Franchise Regulation: Issues and Evidence* 2 J. CORP. FIN. 157 (1997).

[10] American Bar Association Commission on Professional Ethics, Formal Op. 91-360 (1991). Firms may be subject to rules in states where they handle business even if their lawyers are not based there. *See* Michigan State Bar, Standing Committee on Professional and Judicial Ethics, Op. No. RI-225, 1995 WL 68958 (February 1, 1995) (holding that a Michigan lawyer does not violate Michigan rules by having an ownership interest in a DC law firm that has non-lawyer partners permitted by DC rules, but not Michigan, rules, *and* does not handle "Michigan legal matters").

[11] Ethical rules have potential firm-wide ramifications even if the firm is not legally required to monitor because of the firm's interests to ensure ethical compliance. But this blends with the firm's general incentive to maximize the value of its reputation discussed immediately below rather than specifically to comply with potentially conflicting state rules. The firm's reputational bond provides an argument for replacing ethical regulation of lawyers with ethical regulation of firms. *See infra* §IV(A).

forms.[12] The effect of these rules on the firm's structure is illustrated in Figure 1.

[insert figure 1 here]

Regulation of law firms as distinguished from individual lawyers is not a new idea. In particular, Ted Schneyer has recommended firm-wide discipline, making many of the same points about the importance of law firm reputation, or "ethical infrastructure,"[13] as in my later article.[14] Schneyer notes that firms' "good ethical reputation draws clients," and that this reputation may induce lawyers to stay with the firm in order to benefit from that reputation.[15] He points out that some ethical rules are firm-directed, including those relating to the firm's name, prohibiting non-lawyer members, and requiring segregating client money, and requiring firm-wide monitoring structures.[16] Thus, Schneyer suggests court-administered discipline for law firms, malpractice liability, civil sanctions and other firm-directed remedies, a system requiring law firms to register with a disciplinary agency, and requiring lawyers to work only in firms that are subject to disciplinary action.[17] Other writers also have recommended firm-wide disciplinary structures[18] and some states provide for law firm discipline.[19] This concept could gather momentum with recognition of multi-disciplinary law firms because states might decide to permit such firms only if they are subject to a certification process that ensures maintenance of lawyer independence.[20]

This article's approach differs from these developments and recommendations in that, while calls for law firm discipline focus on the benefits of *ethical rules* in protecting clients, this article views *law firm structure* as an alternative mechanism for protecting

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[12] The point here is not that all firms would want to engage in the activities precluded by structural ethical rules, but that the rules impose costs on the firms for which these structures would be efficient but for the restrictions.

[13] *See* Ted Schneyer, *Professional Discipline for Law Firms?*, 77 CORNELL L. REV. 1 (1991).

[14] *See* Ribstein, *supra* note 7.

[15] *See* Schneyer, *supra* note 13 at 12.

[16] *Id.* at 14-16. With respect to firms' monitoring obligations, *see* Model Rules, *supra* note 6, Rule 5.1(a), and note 19, below and accompanying text (discussing state rules that provide for law firm discipline).

[17] *See* Schneyer, *supra* note 13 at 46, n. 276.

[18] See Dzienkowski & Peroni, *supra* note 5 at 204; Susan Saab Fortney, *Am I My Partner's Keeper? Peer Review in Law Firms*, 66 U. COLO. L. REV. 329 (1995).

[19] *See* Cal. Bus. & Prof. Code §6161 (registration as law corporation); 6167 (providing that law corporation "shall observe and be bound by such statutes, rules and regulations to the same extent as if specifically designated therein as a member of the State Bar"); 6169 (providing for disciplinary hearings for law corporations); N.Y. Code of Prof. Resp. DR 1-102(A), 22 NYCRR 1200.3(A) (2000); N.J. Rules of Disciplinary Jurisdiction, Rule 1:20- 1(a) (2000).

[20] *See* Dzienkowski & Peroni, *supra* note 5 at 200-01.

clients.[21] Thus, applying rules on a firm-level basis is not simply a way to more effectively regulate law firms, but also a way to *deregulate* firms in order to free them to adopt more efficient structures for creating and preserving their reputational capital, and thereby more effectively to serve clients. This different perspective has important implications for the method of applying firm level regulation -- that is, by enabling choice of regime rather than through uniform or territorial rules.[22]

A. LIMITED LIABILITY

The most obvious example of a structural ethical rule is one that restricts lawyers' ability to limit their liability for partners' malpractice to the lawyers' interest in the firm's assets.[23] Each state's liability rule has potential firm-wide ramifications. To begin with, vicarious liability for multi-jurisdictional firms cannot easily be contained within particular states. Malpractice plaintiffs in vicarious liability states may seek to reach lawyers' assets in other states. Also, the firm may be subject to vicarious liability even in states that permit limited liability, particularly if the firm erred through letterhead or otherwise by holding itself out in the state as a non-limited-liability firm.[24] And the firm's internal indemnification and contribution agreements may effectively spread the burden of vicarious liability through the firm.

More problems arise to the extent that partners are subject to different legal rules depending on where they live. Partners in limited liability states may have less exposure than those in vicarious liability states because creditors in vicarious liability states have a harder time reaching assets of remote partners than those of local partners, all other things equal (including the ability of partners in both states to use asset protection maneuvers). This is equivalent to requiring partners in vicarious liability states to contribute extra capital to the firm. These obligations complicate contracting within the firm. On the one hand, the contributing partners could be expected to demand governance and financial rights commensurate with their financial obligations. On the other hand, the firm as a whole might prefer to allocate governance and financial rights according to human capital contributions such as rainmaking or fee-generation rather than according to the states in which the firm's members happen to be based.

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[21] Indeed, subpart IV(A), below, considers whether firm-level regulation might replace lawyer-level regulation for lawyers who have joined firms.

[22] Schneyer notes but does not discuss the choice-of-regime issue, *supra* note 13 at 46, n. 276.

[23] For discussions of the law and policy relating to limiting liability in law firms, *see* Alan R. Bromberg & Larry E. Ribstein, BROMBERG AND RIBSTEIN ON LIMITED LIABILITY PARTNERSHIPS AND THE REVISED UNIFORM PARTNERSHIP ACT, §7.04 (2001); John S. Dzienkowski, *Legal Malpractice and the Multistate Law Firm: Supervision of Multistate Offices; Firms as Limited Liability Partnerships; and Predispute Agreements to Arbitrate Client Malpractice Claims*, 36 S. Tex. L. Rev. 967, 980-88 (1995); Susan Saab Fortney, *Professional Responsibility and Liability Issues Related to Limited Liability Law Partnerships,* 39 S. TEX. L. REV. 399 (1998); Susan Saab Fortney, *Seeking Shelter In The Minefield Of Unintended Consequences--The Traps Of Limited Liability Law Firms*, 54 WASH. & LEE L. REV. 717 (1997); Carol R. Goforth, *Limiting The Liability Of General Partners In LLPs: An Analysis Of Statutory Alternatives,* 75 OR. L. REV. 1139 (1996); Jennifer J. Johnson, *Limited Liability for Attorneys: General Partners Need Not Apply,* 51 BUS. LAW 85 (1995); Larry E. Ribstein, *supra* note 7 at 1725-29; Larry E. Ribstein, *Possible Futures for Closely Held Firms,* 64 U. CIN. L. REV. 319 (1996).

[24] *See* Bromberg & Ribstein, *supra* note 23, §7.04.

Virtually every state now recognizes limited liability for law firms in one or more entity forms, including professional corporations, limited liability companies and limited liability partnerships.[25] However, remnants of vicarious liability survive, including the sporadic survival of mandatory vicarious liability for lawyers;[26] imposition of vicarious liability on lawyers who fail to exercise supervision;[27] imposition of vicarious liability when the firm does not meet insurance requirements;[28] and refusal to permit lawyers to practice as LLCs,[29] despite that form's advantages for some law firms.

To the extent that the current system forces law firms to accept some form of vicarious liability, this could hurt rather than help clients.[30] Although vicarious liability might seem to benefit clients by forcing lawyers to back promises of care and loyalty, these benefits are mostly focused in smaller firms. Vicarious liability in large firms offers little value to clients given significant collection costs.[31] Clients are better off relying on these firms' substantial assets and incentives to maintain the value of their reputational capital. Vicarious liability may hurt large firm clients by effectively limiting law firms' size and scope, deterring partners from undertaking supervisory obligations, and making managers reluctant to authorize the firm to represent riskier clients.[32]

B. CAPITAL STRUCTURE

A firm's capital structure consists of the allocation of rights to control the firm and to share in its economic benefits. State ethical and licensing rules directly regulate capital structure by constraining ownership and control by non-lawyers of law firms and by lawyers of non-law firms. Model Rule 5.4 prohibits a lawyer from sharing legal fees with a non-lawyer except under certain circumstances, forming a partnership with a non-lawyer that engages in law practice, or practicing law for profit as a professional corporation or association in which a non-lawyer owns an interest, is a director or officer, or has the right to direct or control the lawyer's professional judgment. Rule 5.7 subjects a lawyer to attorney ethical rules regarding non-legal services that are related to law practice, even if rendered through a separate lawyer-controlled entity, where the client might believe that she is receiving legal services. Rule 5.4 is intended to ensure that lawyers will exercise independent professional judgment in accordance with the values of

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25 *See generally, id.* §7.04.

26 *See* Ill. Sup. Ct. Rules, Rule 721(b), (d), (h).

27 *See* Bromberg & Ribstein, *supra* note 23, §7.04(b). This meshes with lawyers' monitoring responsibility under ethical rules. *See* Model Rule 5.1(a), discussed in *infra* subpart I(F).

28 *See* Bromberg & Ribstein, *supra* note 23, §§2.06, 3.04, 7.04(b).

29 *See* Cal. Corp. Code §17375 (providing that nothing in the LLC act shall be construed to allow LLC to render professional services); R.I. Sup. Ct. Art. II, Rule 10(a) (permitting lawyers to practice as professional corporations or LLPs but not LLCs).

30 *See* Ribstein, *supra* note 7 at 1728-29.

31 *See* Larry E. Ribstein, *The Deregulation of Limited Liability and the Death of Partnership,* 70 WASH. U. L. Q. 417 (1992).

32 *See* Ribstein, *supra* note 7 at 1750.

the legal profession,[33] while Rule 5.7, protects clients' expectations about when legal ethical rules apply to lawyers engaged in non-law businesses.[34]

Pursuant to these rules, if a branch of an integrated multi-jurisdictional firm adopts non-lawyer participation that is prohibited by one of the other states in which the firm has a branch, this could create a problem for the firm's lawyers licensed in the restrictive state, particularly if the lawyers are actually practicing in that state, and possibly even if they are not but the firm is deemed to be practicing in that state.[35]

Potentially infinite gradations of ownership and control by lawyers and non-lawyers exacerbate problems for multi-jurisdictional firms. Several alternatives have been suggested,[36] including: (1) simple cooperation between law and non-law firms; (2) contractual coordination between law and non-law firms involving formalized exchange of information or services; (3) the District of Columbia "command-and-control" rule, which permits joint ownership by lawyers and non-lawyers as long as the latter are subject to lawyer professional rules and the lawyers are responsible for ensuring that they do so;[37] (4) a joint venture to render multidisciplinary services between law and non-law firms that share profits of and control over the venture; (5) a fully integrated firm owned by both lawyers and non-lawyers and offering both types of services in which the lawyers either are, or are not, isolated in a separate department under lawyer control; and (6) an MDP or law-only firm that in either case is owned all or partly by passive equity investors.

These alternatives involve varying problems of lawyer independence and protection of client expectations about the application of legal ethics rules. For example, while all states may allow cooperation between law and non-law firms, states may differ on when this crosses the line into impermissible co-ownership through fee or profit-sharing in an isolated contractual arrangement, a more formalized joint venture, or complete integration. Also, states theoretically could have varying approaches to permitting co-ownership. For example, some states might continue to prohibit any integration, others might follow the D.C. model and permit integration as long as the firm practices only law and lawyers are in charge, and still others might permit integrated firms as long as lawyers are segregated into separate divisions in order to ensure supervision and compliance with ethical rules.[38]

The much-publicized opening of McKee Nelson Ernst & Young in the District of Columbia indicates the uncertainty that might arise.[39] This firm of tax lawyers is tied to

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[33] *See* Model Rules, *supra* note 6, Comments to Rule 5.4.

[34] *See id.* Comments to Rule 5.7.

[35] *See supra* note 10 and accompanying text.

[36] These are reviewed in Dzienkowski & Peroni, *supra* note 5.

[37] *See* District of Columbia, Rules of Professional Conduct, Rule 5.4.

[38] *See generally,* Dzienkowski & Peroni, *supra* note 5.

[39] *See* Jonathan Groner & Siobhan Roth, *Envisoning a Big 5 Law Firm: Ernst & Young Positioning to Offer Full Legal Services*, LEGAL TIMES, Oct. 25, 1999, at 1.

an accounting firm through its name, non-recourse loan financing, support services, and referrals of accounting work. If the loan crosses the subtle line into "equity,"[40] the firm would violate ethics rules in all 50 states, and perhaps also even under the liberal D.C. rule on non-lawyer ownership to the extent that the accountants exercise control or the firm is deemed to be integrated with Ernst & Young. These determinations would be made in any jurisdiction in which the new hybrid firm opens a branch. Moreover, lawyers working for the "parent," Ernst & Young, might face scrutiny in all of the jurisdictions in which they are licensed on the ground that their firm is deemed to be practicing law in D.C. Thus, state regulation based on the location of individual lawyers can affect entire multi-jurisdictional firms and not just local lawyers or branches. This explains the rarity of variations like the one in D.C.

As with restrictions on limited liability, restrictions on capital structure may hurt rather than help clients.[41] Most importantly, effectively forcing law firms to rely on employee financing raises firms' cost of capital and forces firms to engage in second-best forms of financing, thereby increasing the costs and reducing the efficiency of providing legal services. Also, requiring lawyer control of firms that provide legal services encourages these firms to over-recommend or over-perform legal services. By contrast, non-lawyer-controlled integrated firms would seek to maximize profits for the firm as a whole rather than just those attributable to the practice of "law."

At the same time, any benefit of these restrictions in terms of preserving lawyers' independence may be dubious. Ted Schneyer has discussed the patchwork nature of regulation of lawyer independence, including distinctions between legal services and conventional law firms.[42] Regulators cannot seriously want to leave the indigent more vulnerable than large corporate clients of big law firms. This suggests that arguments based on lawyer independence may really be a cover for fears of full-fledged competition in the market for legal services.

It follows that a regulatory system that effectively lets any state veto loosening of capital structure restrictions on multi-jurisdictional firms can preclude evolution of ethical rules toward greater responsiveness to client needs and less responsiveness to lawyer preferences.

C. NON-COMPETITION AGREEMENTS

Model Rule 5.6 bars lawyers from making or offering law firm agreements that "restrict[] the right of a lawyer to practice after termination of the relationship, except an agreement concerning benefits upon retirement." The rule has barred enforcement of agreements that reduce lawyers' post-withdrawal compensation if they compete or remain in private practice.[43] Such agreements are said to restrict lawyers' "professional

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[40] *See* Dzienkowski & Peroni, *supra* note 5 at 165, n. 410; Sheryl Stratton, *Ernst & Young Law Firm Financing Questioned at ABA Meetings*, 86 TAX NOTES 1060 (2000) (noting questions raised as to whether the debt is actually an equity investment).

[41] *See* Ribstein, *supra* note 7 at 1722-25.

[42] Ted Schneyer, *Multidisciplinary Practice, Professional Regulation, and the Anti-Interference Principle in Legal Ethics*, 84 MINN. L. REV. 1469 (2000).

[43] *See* Cohen v. Lord, Day & Lord, 550 N.E.2d 410 (N.Y. Ct. App. 1989); Weiss v. Carpenter,

autonomy" and clients' freedom to choose a lawyer.[44]

As with the other rules discussed above, a state's ban on non-competition agreements affects the basic structure of a multi-jurisdictional firm, and therefore the firm's operation even in more permissive states. Lawyers' incentives to build their own client base rather than the firm's reputation depend not only on their compensation, but also on their ability to defect from their compensation deal by leaving the firm and taking their clients with them.[45] It follows that a multi-jurisdictional law firm might be unable to design agreements to fully align members' and the firm's interests in jurisdictions that do not enforce non-competition agreements. The firm might enter into agreements in restrictive jurisdictions that provide close but imperfect substitutes for non-competes, such as those that attempt to compute liquidated damages for appropriating the firm's investments in its clients.[46] However, it may be costly for the firm to design different agreements for partners in different jurisdictions. Entering into a single nationwide term that is best for the firm but unenforceable in some jurisdictions may leave the firm with no enforceable agreement in the most restrictive jurisdictions. Accordingly, the firm may have to find a compromise term that is enforceable in the maximum number of jurisdictions even if the term would be sub-optimal for the firm in the absence of restrictions.

Despite the rhetoric of enabling client choice, restricting non-competition clauses may hurt most the clients who are least able to protect themselves. Lawyers with a mobile client base have an incentive to cater to the largest and most valuable clients. These are the clients whose "choice" is protected by non-compete bans. Smaller clients would benefit most from the firm's ability to encourage its lawyers to work for the benefit of the firm's reputation, including by devoting time to monitoring and mentoring and to working in teams.[47]

D. CONFLICT OF INTERESTS

Ethical rules prevent lawyers, in the absence of client consent, from simultaneously representing clients with conflicting interests or from later representing a

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Bennett & Morrissey, 672 A.2d 1132 (N.J. 1996); Jacob v. Norris, McLaughlin & Marcus, 607 A.2d 142 (N.J. 1992); Katchen v. Wolff & Samson, 610 A.2d 415 (N.J. Sup. A.D. 1992); Denburg v. Parker Chapin, 624 N.E.2d 995 (N.Y. 1993); McDonough v. Bower & Gardner, 641 N.Y.S.2d 391 (A.D.2d 1996); Judge v. Bartlett, Pontiff, Stewart & Rhodes, 610 N.Y.S.2d 412 (A.D.3d 1994); Whiteside v. Griffis & Griffis, 902 S.W.2d 739 (Tex. Civ. App. 1995). *See also* Blackburn v. Sweeney, 637 N.E.2d 1340 (Ind. App. 1994) (invalidating agreement not to advertise in certain geographic area); Anderson v. Aspelmeier, Fisch, Power, Warner & Engberg, 461 N.W.2d 598 (Iowa 1990) (invalidating reduced payout to a partner who "'committed an act...detrimental to the partnership'" where reduction based solely on clients' decision to follow the withdrawing partners).

[44] See Model Rules, *supra* note 6, comment to Rule 5.6; Jacob v. Norris, McLaughlin & Marcus, 607 A.2d at 151 (stating that "[t]he commercial concerns of the firm and of the departing lawyer are secondary to the need to preserve client choice").

[45] *See* Ribstein, *supra* note 7 at 1735-36.

[46] *See id.* at 1738 (noting that such agreements are not a perfect substitute to bans on non-competes because of the advantages in this context of a property over a liability rule).

[47] *See id.* at 1737-38.

client with a conflicting interest on the same or substantially the same matter.[48] Unlike the rules discussed above, rules restricting conflicts of interest among law firm clients are an important part of any lawyer regulation regime.[49] However, the precise scope of conflicts rules raises important issues. These issues matter because conflicts of interest are potential "smoking guns" that can trigger heavy malpractice damages, as when clients' interests later diverge and the lawyer's advice helps one client at the other's expense. Specific questions concern the extent to which lawyers may engage in potentially harmful conflicts even if they have the client's consent;[50] requirements concerning obtaining the client's informed consent;[51] whether a lawyer's new firm can represent a client whose interests conflict with a client formerly represented by the new lawyer or her former firm;[52] and the circumstances in which imputation of a new lawyer's

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[48]*See* Model Rules of Professional Conduct, Rules 1.7, 1.9; Model Code of Professional Responsibility DR 5-105.

[49] *See* Jonathan R. Macey & Geoffrey P. Miller, *An Economic Analysis of Conflict of Interest Regulation,* 82 IOWA L. REV. 965 (1998).

[50]*See* Model Rules of Professional Conduct, Rule 1.7 (providing that lawyer must "reasonably believe that the representation will not adversely affect the relationship with the other client"); Model Code of Professional Responsibility, DR 5-105(C) (providing that it must be "obvious" that the lawyer can adequately represent both clients' interests).

[51] *See* Ethics 2K Commission, *Report on the Evaluation of the Model Rules of Professional Conduct*, ("E2K"), available at www.abanet.org/cpr/ethics2k.html, Rule 1.0(e) (defining "informed consent" as requiring lawyer to "adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct." *Id.* Comment 5 states:

> The lawyer must make reasonable efforts to ensure that the client or other person possesses information reasonably adequate to make an informed decision. Ordinarily, this will require communication that includes a disclosure of the facts and circumstances giving rise to the situation, any explanation reasonably necessary to inform the client or other person of the material advantages and disadvantages of the proposed course of conduct and a discussion of the client's or other person's options and alternatives. In some circumstances it may be appropriate for a lawyer to advise a client or other person to seek the advice of other counsel. A lawyer need not inform a client or other person of facts or implications already known to the client or other person; nevertheless, a lawyer who does not personally inform the client or other person assumes the risk that the client or other person is inadequately informed and the consent is invalid. In determining whether the information and explanation provided are reasonably adequate, relevant factors include whether the client or other person is experienced in legal matters generally and in making decisions of the type involved, and whether independently represented by other counsel in giving the consent. Normally, such persons need less information and explanation than others, and generally a client or other person who is independently represented by other counsel in giving the consent should be presumed to have given informed consent.

For further discussion of client consent to conflicts, *see infra* note 125.

[52]*See* Model Rules of Professional Conduct, Rule 1.9(b) (barring lawyer in the absence of client's informed consent from representing a person in the same or a substantially related matter in which lawyer's former firm had represented a client whose interests are materially adverse to that person and about whom the lawyer had acquired confidential and material information); 1.10(a) (barring lawyers associated in a firm in some circumstances from representing a client when any would be prohibited from doing so alone). For further discussion of imputing individual lawyers' conflicts to law firms *see* Wolfram, *supra* note 4, §7.6.3.

conflict to the firm may be prevented by screening the lawyer from participating in the matter.[53]

These issues, particularly insofar as they relate to imputing conflicts between lawyers and firms, are important in the context of large, multi-jurisdictional and multi-disciplinary firms.[54] Conflicts between clients obviously become more likely as law firms grow or combine with large accounting firms. Given the vagaries and potential costs of getting client consent, rules regarding screens as a method of vitiating the conflict may become increasingly important.

The structural or firm-wide implications of these rules are apparent. First, a client of any branch of an integrated multi-jurisdictional firm can create a conflict for the entire firm even if other branches are located in jurisdictions with less restrictive conflicts rules. Indeed, the existence of a conflict may depend on conflicting definitions of the "firm" with regard to the integration of branch offices.[55]

Second, it may be efficient for the firm to implement firm-wide structures to deal with conflicts. These would include standardized client agreements and screening procedures that would permit parts of the firm to represent clients whose interests may conflict with those represented by other parts of the firm.

Third, as just noted, conflicts rules significantly affect the size of the whole firm, particularly if it seeks to combine with much larger accounting firms.[56] It follows that rules imposed by one jurisdiction may affect entire multi-jurisdictional firms that have branch offices there.

Strict regulation of client conflicts in multi-jurisdictional firms does not necessarily serve clients' interests. First, such rules increase the total amount of legal work clients must buy by increasing the need to hire multiple lawyers for each transaction. Second, and perhaps most importantly, firms' need to avoid client conflicts inherently limits their ability to grow through accretion and merger, and may cause them to break up where the benefits from conflicting business exceed scale and scope economies.[57] Conflicts rules therefore may prove to be the most potent bar to the success

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[53] See E2K, *supra* note 51, Rule 1.10(c) (permitting new firm to represent client despite lawyer's disqualification if client is informed and "the personally disqualified lawyer is timely screened from any participation in the matter and is apportioned no part of the fee therefrom"); RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS §124 (1998) (describing screening as a method of avoiding imputation); Conflicts of Interest Task Force, *Conflict of Interest Issues,* 50 BUS. LAW 1381, 1402-21, 1426 (1995) (discussing methods of screening off lateral hires from conflicting clients and information in order to provide a basis for client consent to conflict); Comment, *The Chinese Wall Defense to Law-Firm Disqualification*, 128 U. PA. L. REV. 677 (1980).

[54] *See* Dzienkowski & Peroni, *supra* note 5 at 185-86; Daniel R. Fischel, Multidisciplinary Practice, 55 Bus. Law. 951, __(2000).

[55] See E2K, *supra* note 51, Rule 1.0(c) (proposing flexible definition of "firm").

[56] Larger firms not only face more conflicts, but also have an incentive to avoid conflicts by referring clients to specialist "boutique" firms rather than to their direct competitors. *See* Richard A. Epstein, *The Legal Regulation of Lawyers' Conflicts of Interest*, 60 FORDHAM L. REV. 579, 587 (1992).

[57] *See id.* at 587.

of multi-disciplinary firms by constraining the merger of accounting firms' huge client bases with those of large law firms. Conflicts rules may help lawyers and hurt clients by keeping firms sub-optimally small and specialized. The rules thereby serve small firms' interests in protecting themselves from competition by larger, more efficient firms.[58]

It does not necessarily follow from this discussion that all conflicts rules need to be firm-wide. As long as a multi-jurisdictional firm can select the single body of applicable rules regarding imputation of conflicts between firms and lawyers and associated screening rules, rules regarding conflicts between an individual lawyer's clients might be dealt with separately in each state in which the firm's lawyers practice without significantly affecting the structure of the firm as a whole.

E. ADVERTISING AND PROMOTION

Restrictions on law firm advertising inhibit the firm from building its reputational capital. In general, advertising is significant not merely because of its precise content, but because substantial investments in advertising constitute part of the bond the firm offers to secure its quality promises.[59] Since the firm's name is the focus of its advertising and reputation, a firm that seeks a nationwide reputation needs a nationwide name. Restrictions imposed by any state on advertising, name or other forms of solicitation obviously affect the entire firm's reputation-building, and therefore have an effect analogous to that of the other types of rules discussed above.

The Supreme Court has held that broad constraints on lawyer advertising are unconstitutional under the First Amendment,[60] and that a professional association's regulation of quality claims may be subject to Federal Trade Commission scrutiny under the antitrust laws.[61] The American Bar Association explicitly has condoned advertising by television and Internet[62] and the use of trade and common names by multi-jurisdictional firms.[63]

These cases and rules do not, however, eliminate problems arising from state regulation of promotional activities by multi-jurisdictional law firms. States can and do regulate solicitation through direct contact with clients, including electronic contacts.[64]

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58 *See infra* text accompanying notes 77-78.

59 *See, e.g.,* Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance,* 89 J. POL ECON. 615 (1981).

60 *See* Zauderer v. Office of Disciplinary Counsel, 471 U.S. 626 (1985); In re R.M.J., 455 U.S. 191 (1982); Bates v. State Bar of Arizona, 433 U.S. 350 (1977).

61 *See* California Dental Association v Federal Trade Commission 119 S Ct 1604 (1999). It is not clear the extent to which this decision applies to attorney ethical rules adopted by courts and state legislatures.

62 *See* Model Rule 7.2, *supra* note 6, comment 3.

63 *See* Rule 7.5(a)-(b).

64 *See* Model Rule 7.2.

These rules may apply to some advertising through interactive Internet websites.[65] Thus, law firms must be careful to design their websites to conform to the rules of at least all states in which they have branches, and possibly all states in which they could be deemed to be soliciting clients.[66] States similarly may regulate advertising as constituting soliciting clients in states where the firm and its lawyers are not licensed to practice, or restrict some types of trade names as misleading,[67] as where firms seek to use their names to advertise multidisciplinary affiliations.[68] In general, if states' rules leave significant doubt about whether activity is proper, this may deter a firm's promotional activities nationwide.

F. MONITORING THE FIRM

As discussed above,[69] commentators have recommended that firms themselves be subject to ethical discipline and duties regarding breach of ethical obligations by the firm's lawyers, including responsibility for establishing procedures to ensure compliance. The proposed revision of the Model Rules makes this responsibility and obligation clear.[70] This rule obviously has implications for an entire multi-jurisdictional firm. First, a firm that is subject to firm-wide discipline because it has a branch office in the disciplining state may feel the reputational consequences of the disciplinary action even in non-disciplining states. Second, firms may have to adopt firm-wide compliance structures to avoid, or as a result of, discipline in one or more of the states in which they have branch offices. Third, partners or managers who are licensed in the disciplining state may be subject to sanctions regardless of where they live. Because violation of any ethical rule can trigger firm-wide discipline, this discipline in effect confers interstate structural significance on the entire body of ethical rules.

The interstate dynamic regarding firm-wide monitoring obligations differs from that for the other structural rules discussed above. Individual states may be reluctant to make the first move to *deregulate* because the change would have little effect on multi-jurisdictional firms. But a state's *increased* regulation, as by imposing firm-wide

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[65] *See* James Q. Walker, ETHICS AND THE INTERNET, 617 PLI/Lit 297, 310 (October, 1999) (stating that "[w]hether allowing an attorney to advertise and practice over the Internet is like a license to engage in (or at least invite) the unauthorized practice of law is one of the most troubling questions posed by Internet practice").

[66] Pursuant to the Ethics 2000 revision of Model Rule 8.5, the state in which conduct occurs may reach the conduct of individual lawyers, and therefore indirectly the firm. With respect to the state's ability to exercise jurisdiction on the basis of a website, *see generally, see* Committee on Cyberspace Law, *Achieving Legal and Business Order in Cyberspace: A Report on Global Jurisdiction Issues Created by the Internet,* 55 BUS. LAW. 1801 (2000); Jermyu Gilman, *Personal Jurisdiction and the Internet: Traditional Jurisprudence for a New Medium,* 56 BUS. LAW. 395 (2000).

[67] *See* Rule 7.1 (proscribing false or misleading communications).

[68] Thus, the new McKee, Nelson firm was said to have taken advantage of liberality in DC rules regarding trade names to include the name of an accounting firm in that of a law firm. *See* Geoffrey C. Hazard, Jr., *Foreword: The Future of the Profession,* 84 MINN. L. REV. 1083, 1086 (2000).

[69] *See supra* text accompanying note 13.

[70] See E2K, *supra* note 51, Rule 5.1(a) and comments.

discipline, may have national impact irrespective of what other states do. Accordingly, multi-jurisdictional firms not only may find it hard to promote deregulation by the states to reflect modern realities, but also may face increased state regulation in the form of firm-level enforcement of the outmoded rules. For example, a large firm that faces novel exposure to imputed conflicts of interest because of its size also may face firm-wide discipline for failing to adopt structures that deal adequately with these conflicts.

II. CHOICE OF LAW VS. UNIFORMITY

Multi-jurisdictional firms will find it cost-effective to be governed by a single set of structural ethical rules of the sort discussed in Part I. At the same time, under the current state approach to regulating individual lawyers, any state effectively can impose its rules on the entire firm. It has been pointed out that the current complex and ambiguous choice of law regime could subject multi-state law firms to multiple ethical regimes.[71] More seriously and realistically, multi-state firms would have to comply with the most restrictive state rules, which effectively would give national rulemaking power to strict states. Accordingly, it arguably makes sense to have uniform or federal licensing rules that would eliminate firms' risk of being subject to multiple regimes and their need to comply with the most stringent rules.[72] Indeed, the current regime of uniform ABA-promulgated rules can be viewed as a byproduct of a system that would be unworkable without uniformity.

This Part discusses an alternative approach to lawyer rulemaking: allowing firms to choose the applicable state regime, at least regarding the sort of structural rules discussed in Part I. The details concerning the rules that should be subject to this treatment, and any limitations on the enforceability of the firm's choice, will be discussed below in subpart C. For present purposes it suffices to note that, under this "jurisdictional choice" approach, a multi-jurisdictional firm would be able to choose to be licensed in a particular state. The consequence of the choice is that the entire firm would be subject only to the chosen state's structural ethical rules, rather than to the rules of all states in which it maintains branches. This choice-of-law system would eliminate the need for

[71] *See* Duncan T. O'Brien, *Multistate Practice and Conflicting Ethical Obligations*, 16 SETON HALL L. REV. 678, 720-21 (1986); Rensberger, *supra* note 3, 813-14; Committee on Counsel Responsibility, *Risks of Violation of Rules of Professional Responsibility by Reason of the Increased Disparity Among the States*, 45 Bus. Law. 1229, 1235-37 (1990); Note, *Developments in the Law--Lawyers' Responsibilities and Lawyers' Responses*, 107 HARV. L. REV. 1547, 1583-86 (1994); Note, Colin Owyang, *Professional Responsibility and Choice Of Law: A Client-Based Alternative to the Model Rules of Professional Conduct*, 28 U. MICH. J.L. REF. 459, 459-60 (1995).

[72] There have been many calls for federalizing law practice, or predictions that this will occur. *See* Dzienkowski & Peroni, *supra* note 5 at 150, n. 356 (noting that, although there are problems of feasibility, "a strong argument can be made that a federal system for regulating MDPs is the more efficient approach given that many of such entities will operate across state and possibly international borders"); James P. Holden, *Written Remarks to the ABA Commission on Multidisciplinary Practice* (Nov. 12, 1999) (available at <http://abanet.org/cpr/holden.html>) (suggesting opt-in federal system for regulating MDP's); Ted Schneyer, *Professional Discipline in 2050: A Look Back*, 60 FORDHAM L. REV. 125, 129 (1991) (predicting development of a federal regulatory commission by 2015); Fred C. Zacharias, *Federalizing Legal Ethics*, 73 TEX. L. REV. 335 (1994) (considering adoption of uniform federal ethical code). *See also* Chesterfield Smith, *Time for a National Practice of Law Act*, 64 A.B.A. J. 557 (1978) (arguing for state adoption of a national practice of law act under which all states would give full reciprocal recognition to lawyers admitted in other states). For criticism of federalization, *see* H. Geoffrey Moulton, Jr., *Federalism and Choice of Law in the Regulation of Legal Ethics*, 82 MINN. L. REV. 73 (1997).

uniform or federal rules to solve the problem of multiple state regulators of multi-jurisdictional firms. In other words, the benefits of uniform rules depend directly on the feasibility of allowing firms to choose the applicable rules.

Subpart A discusses the potential benefits of allowing jurisdictional choice. Subpart B discusses potential costs of this regime, which can be viewed as benefits of a uniform regime. Subpart C discusses possible limitations on jurisdictional choice.

A. BENEFITS OF JURISDICTIONAL CHOICE

Permitting a multi-jurisdictional firm to choose its licensing state has several advantages over a regime in which the applicable regime is forced on the firm by conflict of law rules, uniformity or federal law.[73] As discussed in subsection 1, states may compete to provide efficient rules. Subsection 2 notes that even if states do not compete, experimentation with different rules still may lead to development of more efficient rules than would emerge under uniformity. Subsection 3 discusses the benefits of having a variety of regimes to suit different types of firms.

1. Competition

An important effect of a jurisdictional choice regime is that it reduces firms' costs of exiting rules it finds oppressive. Increased exit opportunities replace politics, or "voice," as a means of changing the applicable rules.[74] Rather than having to influence the rulemaking process in all jurisdictions in which the firm practices or at the uniform lawmaking level, a jurisdictional choice regime lets firms control the rules that apply to them simply by selecting the applicable state law.

Under jurisdictional choice, the more efficient state regimes at least will come to govern more firms. But increased mobility also can lead to more efficient laws by facilitating active state competition. Losing clientele may cause state rulemakers to change the rules to attract firms as long as rulemakers' interests are aligned with those of their respective states' residents. States' gains from jurisdictional competition depend to some extent on the applicable choice-of-law rules. Law firms might choose the applicable law by forming a business association under that law, as is currently the case for choice of business entity. States might gain by charging fees for local formations. If application of a state's law depends on the firm's having a branch there,[75] states also might gain by attracting assets and jobs.

Increased mobility may not be enough to promote active jurisdictional competition because state lawmakers may lack incentives to increase the state's wealth by participating in the competition. The lawmakers may be lawyers who might lose if more liberal rules attract competitors, or the judges on the state's highest court who see themselves as protecting lawyers' franchise. On the other hand, local lawyers might gain from attracting law firms to the extent that they have an edge in specializing in

[73] *See* Moulton, *supra* note 72; Larry E. Ribstein & Bruce H. Kobayashi, *Economic Analysis of Uniform State Laws*, 25 J. LEG. STUD. 131 (1996).

[74] *See* Albert O. Hirschman, EXIT, VOICE AND LOYALTY (1970) (discussing tradeoffs between exit and voice).

[75] *See infra* §II(C)(1).

malpractice and other law relating to lawyers.

The law may come to look very different under jurisdictional choice than under the current regime. For example, some ethical rules effectively favor small over large firms. Small firms would favor constraints on the growth of large firms because they fear the inherent competitive advantages derived from economies of scale, including those attributable to the value of the firm's reputational bond.[76] Small firms are much more numerous and geographically dispersed than large firms, and therefore have power in uniform lawmaking proceedings and in many state legislatures and bar associations.[77] Even if large firms hold power in some states, a choice of law regime that lets states regulate firms on the basis of presence in the state gives blocking power to a few states, including those controlled by small firms. Moreover, large firms are not a cohesive group, since some may oppose reforms that would help their competitors even if the rules would help large firms as a group.[78] Accordingly, small firms could be expected to hold the balance of power in any system of national rulemaking. Rules that tend to constrain law firm size include the structural rules discussed in this article -- vicarious liability, restrictions on non-lawyer investments, rigid conflict of interest rules, and bans on non-competition agreements that prevent firms from building reputational capital. By contrast, under a jurisdictional choice regime, large firms would want to select jurisdictions that cater to their needs. Some state lawmakers likely would have incentives to enact laws that attract large law firms, just as Delaware invites local formations of large corporations. Smaller states might be particularly interested in attracting big firms' formation fees.

The law regarding multi-disciplinary firms would be particularly likely to be affected by the switch to a jurisdictional choice regime, although the interest group dynamic at work may be more complex than simply small against large firms. Some large firms may fear competition from combinations of even larger firms with Big Five accounting firms. At the same time, some small firms may welcome the opportunity to partner with non-lawyers, although these firms may have less to gain from a change in the choice of law rule than large firms because they are more likely to operate within a single state.

The point here is that whatever interest groups are at work, it is the relative power of these groups that will determine the outcome if the rules are made by uniform state rulemakers or by the most restrictive regime as a result of conflict of laws rules. On the other hand, under a jurisdictional choice regime, individual firms could decide which rules apply to them without having to outgun a competing interest group.

To be sure, the current regime does not prevent all jurisdictional competition. MDPs can undertake global and intrastate business without needing recognition in other states.[79] This gives states incentives to attract new types of firms whatever other states or uniform lawmakers decide to do. However, as long as the rules restrict interstate firms, they will tend to be shaped by politics rather than competition, which will favor the interests of small firms and the continuation of constraints on law firm size.

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[76] *See* Ribstein, *supra* note 7 at 1743-46.

[77] *Id.* at 1745-46.

[78] *Id*. at 1745.

[79] *See* Dzienkowski & Peroni, *supra* note 5 at 150, n. 353.

2. Experimentation

Even without active jurisdictional competition, letting firms choose the applicable structural rules is more likely to promote experimentation with different types of restrictions than a licensing regime that promotes uniformity by forcing compliance with the laws of several states. Experimentation can provide critical data on the extent to which particular restrictions either promote or constrain monitoring and incentive devices that would improve the quality of client services. For example, it may or may not be the case that Professor Matheson's recommendations in his article in this symposium concerning the application of corporate law devices[80] would adequately address any problems with multi-disciplinary firms. It is one thing to propose a plausible theory and another to show that it works. The latter depends on testing alternative structures in the real world. Imposing a uniform rule prevents this testing and potentially locks in sub-optimal structures.

Experimentation, for example, would provide guidance in evaluating the effects of various capital structure restrictions. As discussed in subpart I(B), although these restrictions are intended to help clients by ensuring attorney loyalty to the values of the legal profession, they may hurt clients by forcing them to rely on lawyers' judgments about the need for legal services and by constraining firms from reaching optimal size.

The subtle differences between the various types of multi-disciplinary and non-lawyer-owned firms, ranging from informal cooperation between lawyers and non-lawyer professionals to complete integration, make it hard not only for adjudicators to apply the rules to individual firms, but also for policymakers to determine the appropriate regulatory approach. How do the cost-benefit tradeoffs among lawyer independence, law firm size, and self-interested professional judgment compare as between, for example, discrete contracts for services or information on the one hand, and joint ventures on the other? Does a joint venture with separate management and ownership of the component firms provide enough more protection of lawyer independence than an integrated firm with a divisional structure (i.e., separate management but not separate ownership) to justify permitting one but prohibiting the other? Do the benefits of requiring lawyer D.C.-type "command and control" outweigh the costs of imposing this rigid structural requirement? How do the costs to lawyer independence from non-professional equity investment compare with the benefits of giving legal service firms access to capital markets? Finally, where should lines be drawn among subtle gradations of capital structure such as that involved in the McKee Nelson Ernst & Young situation?[81] Letting multi-jurisdictional firms choose the applicable regulatory regime would provide data on the costs and benefits of the different structures allowed by various states, thereby facilitating the evolution of efficient rules.[82]

To be sure, some experimentation can emerge even without a jurisdictional choice regime. However, jurisdictional choice facilitates experimentation just as it does

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[80] *See* John H. Matheson, *Governance Issues in the Multidisciplinary Corporate Practice Firm*, __ U. CIN. L. REV. __ (2001).

[81] *See supra* text accompanying notes 39-40; Dzienkowski & Peroni, *supra* note 5 at 193.

[82] See Bruce H. Kobayashi & Larry E. Ribstein, *Evolution and Spontaneous Uniformity: Evidence from the Evolution of the Limited Liability Company*, 34 ECON. INQ. 464 (1996).

competition. Enforcing innovations wherever a multi-jurisdictional firm has branches encourages firms to try new structures, and therefore provides more data concerning the effects of different types of rules, than a regime in which jurisdictional choice is not enforced.

3. Variation

Experimentation and competition may lead not to the evolution of a single efficient rule, but rather to an equilibrium in which states have regulations suiting different types of firms.[83] In particular, some states regulate for the traditional model of law-only firm, while others offer more flexible rules designed to attract larger multi-disciplinary firms. A jurisdictional choice regime would thereby offer different regulatory tracks for firms that operate wholly within a single state and for firms that operate interstate. Intrastate firms generally would be governed by the more traditional rules of the states in which they have their only physical locations. Qualifying as a foreign firm in an operating state other than the formation state imposes additional cost on intrastate firms but not on firms that operate in multiple states. Moreover, the costs of choosing a state's law will tend to be higher per unit of capital for smaller firms.[84] Thus, the two regulatory tracks would reflect differences between large and small firms. Looser regulation might make sense for larger firms that can substitute substantial reputational bonds for regulatory oversight and constraints. On the other hand, smaller firms with less valuable reputations would induce clients to deal with them by choosing to organize under a restrictive ethical regime. The firms would, in effect, borrow the reputational capital of the regulatory regime.

Alternative regulatory systems might reflect firms' preferences that turn on factors other than size. Even large multi-state firms might choose to register under uniform or ABA-approved rules that have acquired credibility with clients and therefore can serve as an accrediting mechanism. Moreover, tighter regulation may facilitate internal contracting by protecting partners against changes in the contract. In particular, a lawyer who wishes to avoid working for a multidisciplinary firm may be reassured by the fact that her firm is licensed by a jurisdiction that prohibits such firms. Although the firm still might change jurisdictions, this may require more consensus among members than simply amending the contract.[85]

B. WILL THERE BE A RACE TO THE BOTTOM IN STRUCTURAL RULES?

The jurisdictional choice regime arguably might lead to a "race to the bottom" in that large multi-jurisdictional firms will choose to be governed by rules that favor their

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[83] *See* Schneyer, *supra* note 13 at 28 (noting problem with uniform rules given differences in types of firms).

[84] A rule that permits a firm to choose to be governed only by the law of a state in which it maintains a branch office (*see infra* §II(C)) obviously increases the distinction between intrastate and interstate firms.

[85] The jurisdiction also might change its rules. However, to the extent that the rules are part of the contract among the firm's members, such changes may have to be prospective only in order to comply with the contract clause of the Constitution. *See generally*, Henry N. Butler & Larry E. Ribstein, *The Contract Clause and the Corporation*, 55 BROOK. L. REV. 767 (1989), reprinted in *Property Rights in American History*, vol. 6 (James W. Ely, Jr., ed., 1997).

own interests at the expense of clients and society. States, for their part, may seek benefits from being havens for large firms, such as formation fees and business from branch offices, while imposing most of the costs on out-of-state clients who are unable to bargain effectively over the firm's choice of licensing regime. The main issue concerning the existence of a race to the bottom is whether a firm's choice of regulatory regime is likely to be disciplined in its product market. In other words, will clients shun or pay less to firms that choose regimes that offer less protection for clients?

At first blush it seems that clients would be unable to make sophisticated determinations concerning the applicable ethical rules. Indeed, an important justification for ethical rules is that legal services are "credence" goods whose value clients cannot practicably determine until after they are delivered.[86] Thus, clients may not easily be able to determine whether lawyers will serve their interests prior to engaging them. Ethical rules address this problem by deterring lawyers' self-interested conduct. Many rules, including the structural ethical rules discussed in this article, are prophylactic in that they proscribe conduct that may not itself be harmful but that tempts lawyers to act contrary to clients' interests. For example, non-lawyer-run firms arguably do not adequately encourage lawyers to exercise their independent legal judgment consistent with the ethics of the legal profession. Similarly, freeing lawyers from legal responsibility for the conduct of others may lead to more client harm, and permitting lawyers to represent conflicting interests may decrease the vigor of legal representation. Ethical rules applying to all lawyers arguably are justified because clients cannot tell when they employ a lawyer whether she will perform faithfully. It arguably follows that clients may be unable to evaluate the effect of opting out of ethical rules. As discussed below, however, these arguments paint an unduly bleak picture of clients' plight under a jurisdictional choice regime.[87]

1. Choice of regime vs. choice of contract term

It is important to emphasize that, despite its contractual elements, enabling jurisdictional choice differs materially from complete deregulation. To be sure, a jurisdictional choice regime may seem tantamount to deregulation because it lets the regulated parties themselves ultimately decide on the extent to which they want to be regulated. But there are two significant differences between choosing contract terms and choosing regulatory regimes. First, while contract terms are limited only by contracting

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[86] *See generally* Michael R. Darby & Edi Karni, *Free Competition and the Optimal Amount of Fraud,* 16 J. L. & Econ. 67, 68-69 (1973); Ellen R. Jordan & Paul H. Rubin, *An Economic Analysis of the Law of False Advertising,* 8 J. LEG. STUD. 527, 530-31 (1979). For an application to legal services, *see* Ribstein, *supra* note 7 at 1712-13.

[87] The discussion focuses on the effect of jurisdictional choice on lawyer-client agency costs. There are additional issues concerning the effect on third-party interests arguably protected by lawyer regulation. For example, lawyers may have ethical duties to disclose client fraud or misconduct, or to perform pro bono work as a condition of maintaining bar membership. Clients themselves may have incentives to internalize these costs as by contracting regarding lawyer disclosure. *See* Richard W. Painter, *Toward a Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules*, 63 GEO. WASH. L. REV. 221 (1995) (suggesting enabling clients to choose firms according to whether they disclose client wrongdoing). In other situations, such as pro bono work, clients may be indifferent to third party interests but the regulation may actually help lawyers by highlighting their standing as a profession or by serving as a barrier to entry. *See* Richard A. Posner, OVERCOMING LAW 56 (1995). In any event, the important point for present purposes is that third party interests do not appear to be implicated in the sort of law firm structural rules discussed in this article.

parties' imagination, jurisdictional choice is limited to 51 sets of rules. This makes it less costly to compare the costs and benefits of various rules as compared to a purely contractual regime.[88] All things equal, more information will be available through various media, including magazines and the Internet, about each state regime than about each of many potential private contractual provisions.[89] If, for example, Delaware or Nevada decided to become a haven for rogue law or multidisciplinary firms, the media probably would notice. As long as firms must disclose their choice of regime,[90] clients can make an informed judgment about whether to deal with the firm.

Second, each set of rules must pass through a political process involving publicity, opportunity for public participation, and public accountability of lawmakers. This article's proposal enhances this discipline by requiring firms to choose entire bodies of ethical rules rather than only the most favorable rules from various states.[91] To be sure, these features are more characteristic of statutes than of bar rules, but even the latter entail some dissemination of information and opportunity to comment, including by non-lawyers. Political agencies may be explicitly involved to the extent that the state supreme court ultimately is responsible for the rules, or that the state in effect backs the rules through licensing laws that forbid the practice of "law" by those who are not bound by the rules. To the extent that lawyers draft the rules, the reputations of lawyers who participate in ethical rulemaking may be even more vulnerable than those of politicians. Lawyer-rulemakers therefore are even less likely to promote radical deregulation than politicians. Indeed, lawyer-rulemakers have strong incentives to be too conservative and resistant to change and to promote traditional restrictions on law firms, as emphasized throughout this article.

2. Market discipline of choice of regime

Even if many clients face difficulties in evaluating constraints on lawyers' performance, this does not necessarily mean that enabling jurisdictional choice will lead to a race to the bottom in lawyer regulation. In general, where vendors face high costs of discriminating between informed and uninformed customers, firms' competition for informed customers protects uninformed consumers.[92] Given the publicity that is likely to surround deregulation, clients would be aware of firms' choice of a deregulatory regime as long as firms were required to disclose prominently their jurisdictional choices.

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[88] Because this article proposes that firms be allowed to choose licensing regimes, firms will have to select entire state bundles of rules rather than individual rules from many jurisdictions. *See infra* §II(C)(5).

[89] Individual contractual provisions might become as notorious as state laws through wide use or firms' publicity. The point in the text is that there is greater potential for notoriety for state laws than for private contractual provisions keeping such mechanisms constant between the two alternatives.

[90] *See infra* §II(C).

[91] *See infra* §II(C)(5); Erin A. O'Hara & Larry E. Ribstein, *From Politics to Efficiency in Choice of Law*, 67 U. CHI. L. REV. 1151, 1192-94 (2000) (discussing how bundling minimizes the effect of bargaining and information disparities relating to contractual choice of law).

[92] See Alan Schwartz & Louis L. Wilde, *Intervening In Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630 (1979).

Moreover, the branch office requirement in this article's proposed rule helps provide market discipline by ensuring that only multi-jurisdictional law firms can take advantage of jurisdictional choice. Multi-jurisdictional firms tend to serve sophisticated corporate clients whose legal departments can carefully evaluate the firm's outside law firm, including both that firm's choice of regulatory regime and any internal controls that reduce the need for external regulation.

3. Reputational incentives

An important explanation for the sort of large, multi-jurisdictional firms that would take advantage of jurisdictional choice is these firms' ability to bond their promises to clients with substantial reputational capital.[93] In order to maintain their competitive advantage, firms would be expected to maximize the value of their reputational assets as they would any other assets. This includes not only developing contractual devices but also choosing a regulatory regime that builds and maintains the firm's reputation. Firms accordingly have strong incentives not to devalue their reputations by choosing to be regulated by notoriously lax regimes unless the gains from greater flexibility exceed the reputational costs. This suggests that firms themselves should decide the appropriate level of regulation by choosing the applicable regime. Law firms not only know more about themselves but also have better incentives to choose the appropriate regulatory regime than do external rulemakers.

C. SUGGESTED RULE

Under Model Rule 8.5 lawyers are subject to the ethical rules of the jurisdiction in which the court sits for conduct in a judicial proceeding, local rules if the lawyer is licensed locally, or the rule where the lawyer principally practices unless the lawyer's conduct has its predominant effect in another jurisdiction where the lawyer is licensed. Under the Proposed E2K revision, lawyers would be subject to discipline wherever they render or offer to render legal services or where their conduct had its predominant effect whether or not admitted in these jurisdictions.[94] Moreover, the proposed revision would subject law *firms* to disciplinary rules,[95] suggesting that a state can regulate an entire multi-jurisdictional firm that has a local branch. Thus, in an era of expanding interstate nature of law practice, rather than recognizing the problems of multi-state regulation, the ABA is moving toward expanding application of ethical rules and discipline based on where conduct occurred rather than where lawyers choose to be licensed.

Lawyers also are subject to rules in state statutes governing professional corporations, LLCs and LLPs that are formed by law firms. These statutes regulate, among other things, the members' liability, the nature of its business (that is, the rendition of a particular type of professional service), and the firm's name.[96] Law firm business associations may do business outside their states of formation under formation state rules,

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[93] *See supra* text accompanying note 8.

[94] *See* E2K, *supra* note 51, Model Rule 8.5.

[95] *See id.,* Model Rule 5.1.

[96] *See* Ribstein & Keatinge, *supra* note 25, §4.10 (discussing purpose restrictions on LLCs); 4.11 (discussing name restrictions); 12.02 (discussing liability of LLC members); 15.14 (discussing use of LLC form by lawyers); app. 4-1 and 12-1 (tabulating state statutory provisions).

but only consistent with the operating state's professional regulation.[97] Thus, the "internal affairs rule" that subjects a business association only to the organizational rules of its state of formation does not apply to many aspects of law firms.

This article proposes to change this regulatory scheme. It suggests permitting law firms to choose to be governed by a particular state's rules regarding the types of "structural" matters discussed in this article. The rules could be provided for in the selected state's ethical code or, as with rules on limited liability, capital structure and name, through business association statutes. In order to ensure application of those rules in the states in which the law firms operate, this article advocates that Model Rule 8.5 be made subject to a new subsection (c) providing for determination of the rules applicable to a law firm as discussed in this subpart. The proposed subsection would provide as follows:

> A firm[98] may provide in its agreement for the application to the firm and its members of the rules of disciplinary conduct of a jurisdiction in which the firm maintains a branch office. This provision shall be enforced as to the matters covered in Rules 1.10, 5.1-5.7, and 7.1-7.6,[99] provided that the firm gives notice of the applicable jurisdiction in its name and as otherwise required by the applicable jurisdiction.

The following subsections discuss the details of the proposed rule.

1. Retention of the default rule

In the absence of an agreement that provides for application of the rule of a particular jurisdiction, the proposed rule would apply current default rules based on individual lawyers' locations. An alternative would be to apply a firm-related default rule that looks to the location of the firm's chief executive office, similar to the "real seat" rule that still prevails for European corporations.[100] This approach would have the advantage applying a single state's structural rules to all firms even in the absence of advance planning. It is also consistent with the default internal affairs rule applied to partnerships under the Revised Uniform Partnership Act.[101]

The disadvantage of a default rule relates to transition. Because the default rule would change the existing choice-of-law rule, clients would have the same need for disclosure of the applicable law as they do when the firm drafts for it.[102] Thus, application of a home-office New York rule may surprise clients of the firm's Chicago office. At the same time, some firms to which the default rule would apply, such as

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[97] *See* Bromberg & Ribstein, *supra* note 23, §7.04.

[98] *See* E2K Commission, *supra* note 6, Model Rule 1.0 (defining "firm").

[99] These rules are summarized on Table 1.

[100] *See generally,* Richard M. Buxbaum & Klaus J. Hopt, *Legal Harmonization and the Business Enterprise* 68-79, 227-28 (1988).

[101] R.U.P.A. §106 (1997).

[102] *See infra* subsection II(C)(4).

smaller firms with a single outlying branch, may not even be aware they are making the choice, thus making a disclosure requirement a potential trap. Moreover, as this article emphasizes, the choice-of-law rule is important mainly to assist the firm in engaging in firm-specific planning and drafting. Thus, it is reasonable to expect firms that need the choice-of-law rule to include it in their agreements.

2. Application to "structural" rules

The proposed regime is based on the potential spillover of regulatory costs that results where states effectively can regulate national law firms solely on the basis of local contacts.[103] In these situations, there is a particular justification for restricting states' power to impose regulation on the basis of territorial connections. In general, structural rules have important effects on the firm as a whole rather than solely on individual lawyers. For the reasons discussed in Part I, they include the following categories of rules: Regulation of the firm's capital structure, including restrictions on limited liability and non-lawyer owners,[104] regulation of non-competition agreements;[105] imposition of monitoring duties on or within the firm;[106] imputation of conflicts between lawyers and their firms;[107] regulation of firm advertising and name;[108] and, most obviously, conflict-of-laws rules.[109] On the other hand, the suggested approach does not apply, for example, to standards of competence and diligence applicable to individual lawyers, or to individuals' conduct in trials and other proceedings, which in any event is likely to be regulated in each tribunal.

3. The branch office requirement

The suggested regime would permit choice only among those state regimes in which the firm has a branch office.[110] In other words, this paper does not advocate a corporate-type internal affairs rule that lets the firm select any state regardless of whether

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[103] It might be argued that analogous problems apply to individual lawyers and single-jurisdictional firms. Although lawyers normally practice only in their states of residence, even individual lawyers increasingly are practicing nationally, as through the Internet. The arguments for and problems with extending the jurisdictional choice regime to individual lawyers are discussed in *infra* subpart IV(B).

[104] *See* Model Rules 5.4 (relating to professional independence); 5.7 (relating to provision of law-related services).

[105] *See* Model Rule 5.6.

[106] *See* Model Rules 5.1-5.3. Note that these rules also may have implications for vicarious liability.

[107] *See* Model Rule 1.10.

[108] *See* Model Rules 7.1-7.6.

[109] *See* Model Rule 8.5. *See also* Model Rule 5.5 (recognizing as unethical unauthorized practice of law in states other than where lawyer is licensed).

[110] Because "branch" is intended to distinguish multi-jurisdictional from uni-jurisdictional firms, the term should be defined to include a physical office with which lawyers are permanently affiliated and that conducts business with clients.

it has a substantial presence there. Although, as discussed above, sophisticated clients and the media are likely effectively to screen firms' regime choices, and firms have reputational incentives to choose responsible regulators, the market is unlikely perfectly to discipline firms' choice of ethical rules. Most importantly, unlike the corporate internal affairs context, jurisdictional choice is not priced in efficient capital markets.[111]

The main advantage of a branch office rule is that it implicitly focuses jurisdictional choice on the larger firms that have such offices, rather than enabling such choice by smaller firms based in a single state. Larger firms are likely to have more reputational capital, which substitutes for ethical rules in inducing the firm to police lawyer-client agency costs. Also, the problem of an individual state's externalizing the costs of structural ethical rules by effectively regulating national firms applies less to single-jurisdiction firms.

4. Disclosure

Jurisdictional choice assumes some public disclosure to potential clients of the chosen regime. The proposed rule requires at least identification in the firm's name, such as "ABC, a Delaware LLP." The applicable statute may provide for other rules, such as disclosure in a central filing and inclusion of the firm's name on all correspondence. Compliance with organization-state disclosure requirements would be a prerequisite to enforcing the firm's regime choice both within and outside of the chosen jurisdiction. However, it is important to emphasize that, consistent with this article's general approach, the rules regarding disclosure, including those relating to the firm's name, are given by the single jurisdiction the firm has chosen rather than by each state in which the firm practices.

5. The applicable jurisdiction: bundling

Under the proposed regime, a firm would be permitted to choose only the entire body of rules of a given jurisdiction. In other words, the firm would have to "bundle" jurisdictional rules rather than picking and choosing rules from different jurisdictions. This has the effect of constraining firms' choice, providing clearer notice to clients of which rules apply, and preserving any complementary effects of multiple rules in a given jurisdiction.[112]

A bundling rule effectively requires a firm to choose the same jurisdiction for structural ethical rules as that in which it organizes as a business association. Business association statutes include at least the jurisdiction's provisions concerning limited liability and probably also those concerning the firm's name as well. One possible effect

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[111] To be sure, efficient market pricing does not occur for closely held corporations, which nevertheless can shop for internal governance rules. But this is not a serious problem because closely held firms are unlikely to take full advantage of shopping for law: the costs of operating as a foreign corporation are higher for such firms than for publicly traded firms in relation to the overall cost of capital. Also, in the usual internal affairs rule setting, the main affected parties are the owners themselves who have repeat dealings and therefore are in a better position to negotiate for protection than outside clients of law firms. Although third parties are affected by limited liability rules, these are relatively uniform across jurisdictions.

[112] *See* O'Hara & Ribstein, *supra* note 88 at 1192-94 (discussing advantages of bundling choice of law rules).

of this article's proposal may be to encourage states to include other structural ethical rules in their professional business association statutes. Another may be to encourage a state competition for professional firm formations, albeit one that is more constrained than a corporate-type competition because of the branch office requirement.

6. Disciplinary authority

This article's proposal deals with choice of law rather than of regulatory jurisdiction. It focuses on law firms' need to be subject to a single set of structural rules. Thus, a law firm might be subject to discipline in any jurisdiction in which it operates under the structural rules the firm has selected. Although firms also might be permitted to select the disciplinary jurisdiction as well, and this would have the benefit of giving jurisdictions an incentive to become efficient adjudicators of ethical issues, this choice presents issues distinct from those raised in this article.

III. THE EVOLUTION OF JURISDICTIONAL CHOICE

How can or should the jurisdictional choice regime suggested above be adopted? As discussed above, the problem with current rules is that a single state can block rules that have firm-wide implications by imposing its own rules on a local branch rather than enforcing the rules the firm as a whole has selected. This regime may be impeding change regarding non-lawyer ownership, thereby effectively requiring resolution of the issue through uniform rules. What would lead the states or uniform lawmakers to switch to a regime under which the firm's choice of regime is enforced? This apparently presents a chicken and egg problem, where one reform depends on another.

The obvious response might seem to be federal law. This does not mean federal substantive regulation of the legal profession, which would pose even more severe problems than uniform state law in terms of locking in a single system and foreclosing state variation, competition and experimentation.[113] Rather, Congress might enact a law compelling the states to enforce a firm's choice of regime. This approach arguably would not present the dangers of federal substantive regulation.[114]

There is, however, little reason to expect such help from Congress.[115] The interest groups that might be effective in pushing for federal regulation of the legal profession, such as consumer groups, would be seeking substantive reform and not a way to, in effect, make the states more effective regulators. In any event, Congress is likely to be very reluctant to move against the strong lawyers' lobby and to usurp long-standing state power.[116] Finally, even if Congress were to adopt a federal jurisdictional choice regime for lawyers, there is no guarantee that the result would improve on the current system, while federal law would forestall further state experimentation on choice of law.

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[113] *See supra* note 72 and accompanying text.

[114] *See* Moulton, *supra* note 72.

[115] For a general discussion of the problems of federal choice of law rules, *see* O'Hara & Ribstein, *supra* note 88.

[116] *See* Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward A Public-Choice Explanation of Federalism*, 76 VA. L. REV. 265 (1990).

This Part presents alternative scenarios for change. In general, as changes in law practice and competition from other specialties increase the costs imposed by constraining law firm organization, they commensurately increase firms' and clients' benefits from exploring ways to escape these restrictions. The persuasive economics of multi-disciplinary law firms and the competitive threat posed by large accounting firms and foreign law firms are compelling incentives for change. Accordingly, firms can reap significant benefits from changing or avoiding the current restrictions, and states can reap benefits from being first movers in deregulation.[117] Indeed, several states appear poised to deregulate.[118]

Jurisdictional choice for law firms must, of course, begin with some states' adoption of rules that apply to law firms rather than merely to individual lawyers. As discussed above, states may offer structural ethical rules as part of their business association statutes, so that these rules may become part of the conventional competition among state business association laws.[119] State competition in this respect may be spurred by two developments. First, as discussed above, states are moving toward disciplining law firms rather than merely lawyers.[120] Second, this trend could accelerate if states decide to authorize and regulate multi-jurisdictional law firms.[121] As states move toward regulating multi-disciplinary law firms, they will have to adopt some sort of structure for regulating law firms generally. It would be a relatively short step from there to law firm rules governing other than simply ownership, including rules on imputing conflicts and non-competition agreements.

Law firms' jurisdictional choice can be effective only if states in which multi-jurisdictional firms operate branches enforce this choice rather than imposing their own inconsistent rules. The important question is whether law firm regulation will lead to enforcement of jurisdictional choice or to states' increasing their ability to regulate entire nationwide firms through their branch offices.

The following subparts discuss ways states could be led to recognize law firms' choice of other states' structural rules. Although some may be skeptical that states ever would come to enforce other states' ethical rules under a choice-of-law regime, it is important to keep in mind the significant evolution toward contractual choice of law that has occurred in other areas, particularly including corporate law.[122] Corporate law provides the closest analogy because there, too, states came to relinquish the prerogative of local regulation of the internal structure of firms, first through the transition from special to general incorporation laws, and later through the spread of non-corporate limited liability, including in law and other professional firms.

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[117] *See* Dzienkowski & Peroni, *supra* note 5 at 150.

[118] For a summary of the states' current positions on multi-disciplinary firms, *see* Mona L. Hymel, *Multidisciplinary Practice: The States Weigh In*, 88 TAX NOTES 261 (2000).

[119] *See supra* §II(C)(5).

[120] *See supra* text accompanying notes 18-19.

[121] *See supra* note 20 and accompanying text.

[122] *See* Bruce H. Kobayashi & Larry E. Ribstein, *Contract and Jurisdictional Freedom,* in The Fall and Rise Of Freedom Of Contract, (F.H. Buckley, ed. Duke, 1999).

A. INCENTIVES TO ATTRACT BRANCH OFFICES

State lawmakers will be subject to conflicting incentives regarding enforcement of law firm jurisdictional choice. Some interest groups would oppose local restrictions that would discourage entry by multi-jurisdictional law firms. Individual and business consumers of legal services would want a broad variety of providers from which to choose. Also, some lawyers would want to be able to practice with branches of out-of-state firms. On the other hand, local lawyers may fear competition from multi-jurisdictional firms. As new organizational forms become more attractive, and therefore social welfare losses from barring these forms rise, the benefits to interest groups that favor competition may outpace losses to groups that oppose competition. At some point, even allowing for interest group coordination costs, change may become politically inevitable.[123]

The politics of state recognition of jurisdictional choice for law firms differ from those regarding the spread of business association statutes. In the latter case, locals' opposition to limited liability was more diffuse, consisting mainly of tort creditors and their lawyers who might be concerned about the spread of limited liability. Once the states recognized corporate limited liability, expansion into other limited liability organizational forms imposed relatively small additional costs on locals.[124] Thus, local acceptance required only relatively small benefits to locals, as from firms' greater willingness to locate assets in states that recognized jurisdictional choice.

By contrast, local benefits from multi-jurisdictional law firms will need to be greater to defeat the more concentrated local opposition to the spread of new types of law practice. The conundrum is that these benefits may be associated with bigger competitive threats to local lawyers. Accordingly, the factors discussed in the following subparts are likely to be more significant than local benefits from branch offices alone in promoting acceptance of a jurisdictional choice regime.

B. ENFORCING CLIENT CONSENT

States could allow lawyers to avoid violation of structural rules through client consent to the firm's selection of firm-wide rules. This could come in the form of explicit client consent letters. Courts also might enforce a more implicit form of consent manifested by clients' willingness to deal with a firm that clearly discloses through its name that it is operating under another state's rules. Some authority for this enforcement can be found in commentary, rules and cases supporting or recognizing enforcement of advance waiver of attorney-client conflicts.[125] This authority is significant because

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[123] *See* Gary Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q. J. ECON. 371 (1983).

[124] *See* Ribstein, *supra* note 31.

[125] *See* American Law Institute, RESTATEMENT OF THE LAW GOVERNING LAWYERS, §202, comment d (providing that "[a] client might. . . give informed consent in advance to the types of conflicts that are familiar to the client"); E2K Rule 1.7, Comment 22 (recognizing enforcement of advance consent to conflicts particularly for sophisticated clients who understand risks); Richard W. Painter, *Advance Waiver of Conflicts*, 13 GEO. J. LEG. ETH. 289 (2000) (discussing cases enforcing advance consents to conflicts and recommending amendment of Model Rules to explicitly permit enforcement of advance waivers of conflicts where client has separate legal representation).

conflicts of interest arguably present greater potential dangers to clients than the matters covered by the other ethical rules discussed in this article. A choice-of-law clause in an engagement letter regarding the law applicable to conflicts might be enforced as one type of advance waiver.[126]

To be sure, courts may be reluctant to find informed consent in this situation, particularly by unsophisticated clients who are not separately represented by counsel.[127] Courts and regulators might conclude that such contracts present extra dangers because a firm's choice of a regulatory system does not itself disclose the rules being selected, and therefore the risks the client is taking. On the other hand, waiver through choice of law arguably involves less danger than direct waiver because, as discussed above in subpart II(B), ethical rules are subject to political discipline and unusual state ethical rules may be sufficiently notorious that the market can adequately discipline jurisdictional choice. Moreover, courts may come to enforce choice-of-law contracts at least in situations involving sophisticated clients or those, like corporate clients, who have separate legal representation -- arguably the typical situations in the multi-jurisdictional law firm setting.

C. LOOSENING UNAUTHORIZED PRACTICE RULES

A third route to recognizing jurisdictional choice would be through liberalizing unauthorized practice rules. Several states have special rules or practices permitting lawyers who are not admitted locally to act in some capacities as in-house corporate counsel.[128] By contrast, lawyers based in branch offices of law firms generally must obtain a local license.[129]

There is no clear reason for distinguishing in-house and law firm lawyers regarding the need for a local license. States' tolerance for the former reflects to some extent the difficulty of disentangling legal from business advice in this setting. But this does not apply to lawyers working for corporate legal departments who are clearly practicing law. It might also be argued that the corporate employer of an in-house lawyer does not need the protection of ethical rules. However, the same principle should apply at least to lawyers who serve as outside counsel to large corporate clients. Moreover, the law firm's reputational bond[130] protects small as well as large clients. And the problems of requiring local licensing are, if anything, more serious for law firms than in the

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[126] See ABA Task Force on Conflicts of Interest, *Conflicts of Interest Issues,* 50 BUS. LAW. 1381, 1426 (1995) (suggesting that firms include choice-of-law clauses in engagement letters to deal with client conflict issues).

[127] With respect to the definition of a "sophisticated" client, *see* Theodore J. Schneyer, *Corporate Practice and the Development of the "Sophisticated" Client as a Regulatory Term of Art*, __U. CIN. L. REV. __ (2001).

[128] *See generally* www.abanet.org/cpr/mjp-uplchart.html (chart tabulating state rules on practice by in-house counsel, listing about a dozen states with such rules).

[129] Wolfram, *supra* note 4 at 868-9 notes that lawyers not locally admitted may be able to do some work in their firm's branch office, including research, under supervision of a locally admitted lawyer. However, these rules aren't enough to accommodate lawyer who is based in a branch office.

[130] *See supra* text accompanying note 7.

corporate counsel context. Because in-house corporate lawyers often are located only at headquarters, corporations have less need for coordinating the rules across jurisdictions than do law firms. Accordingly, there would seem to be little policy basis for a sharp distinction between in-house than for law firm lawyers. States may come to recognize this by applying rules adopted in the former context to the latter context as well.[131]

D. CONTRACTUAL ALTERNATIVES AND DEREGULATION

States' resistance to enforcing jurisdictional choice depends to some extent on the effect of the state regulation firms would be avoiding by exercising their choice. This, in turn, depends on firms' alternative contractual methods of avoiding regulation. In particular, firms have many nearly fungible contractual alternatives to the structures ethical rules restrict. Thus, regulation of the structure of firms, including law firms, is particularly difficult and unstable. This has been demonstrated repeatedly throughout the history of the law of business associations. For example, the parties have contractually eroded apparently mandatory rules, such as those prohibiting voting trusts or requiring appraisal rights.

All of the structural ethical rules discussed in this article are susceptible to contractual erosion. Ethical rules prohibit non-lawyer ownership of law firms, but the concept of ownership cannot readily be confined. For example, Ernst & Young's debt investment in the McKee Nelson law firm[132] may or may not be characterized as equity depending on the accounting firm's control and form of payoff. Many kinds of contracts, including joint ventures, may skirt the ownership line.[133] Thus, the definition of a law "firm" for purposes such as imputing conflicts of interest may be subject to contractual manipulation.[134] Also, ethical restrictions on non-competition agreements must distinguish legal multi-level payouts based on potential damage caused by the departing partner from illegal non-competes.[135]

To be sure, contractual manipulation does not make jurisdictional choice irrelevant. Because contractual alternatives are not fully fungible, firms may be better off selecting a permissive regulatory regime than trying to contract around the rules of a less permissive regime. Moreover, clearly authorized agreements or clear default rules provide more predictability than experimenting with contractual alternatives that some states may not enforce. But the availability of contractual alternatives may pave the way to enforcement of jurisdictional choice by reducing the stakes involved in the enforcement decision. If firms can minimize the effect of strict regulation by contracting around it, interest groups have less to gain from opposing jurisdictional choice.

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[131] *See infra* text accompanying note 139.

[132] *See supra* text accompanying notes 39-40.

[133] For discussions of alternative ownership structures at the borderline of the economic "firm," *see* Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990); Larry E. Ribstein, *Limited Liability Unlimited*, 24 DEL. J. CORP. L. 407 (1999). For discussion of borderline cases involving the definition of partnership, *see generally*, Alan R. Bromberg & Larry E. Ribstein, BROMBERG & RIBSTEIN ON PARTNERSHIP, ch. 2.

[134] *See supra* note 55 and accompanying text.

[135] *See* Ribstein, *supra* note 7 at 1732.

E. REGIME CHOICE AS A COMPROMISE SOLUTION

States may find themselves under increasing pressure to deregulate from firms and from courts and regulators who are concerned about the anti-competitive implications of restrictions on law firm structure. Offering firms a choice of regime provides a compromise that may mollify both firms that favor deregulation and interest groups that oppose change, and thereby may make change politically palatable.[136] In particular, it lets regulators maintain more restrictive rules for the smaller intra-state firms for which these rules are most appropriate, while offering more freedom for the inter-state firms for which deregulation is both most appropriate and most demanded.[137]

IV. EXTENDING THE ANALYSIS

This article proposes a relatively modest move in the direction of jurisdictional choice of ethical rules. It applies only to a limited set of rules and permits choice by firms rather than individual lawyers. This section considers the extent to which the foregoing analysis might justify a broader jurisdictional choice regime.

A. FIRM-BASED REGULATION OF LAWYERS

This article's proposal concerns specific rules that would apply to firms as such. This raises the question whether the analysis might justify broader regulation at the level of the firm rather than of individual lawyers. One possibility is applying a law firm's choice of all the rules of the chosen state's ethical regime to all lawyers in the firm. Thus, a lawyer based in the Chicago office of a law firm that has selected New York law would be governed for all purposes by New York ethical rules.

The analysis in this article provides some support for such a rule. As discussed above, state discipline of law firms, by involving the state in monitoring a firm's compliance with ethical rules, can give any ethical rule structural implications.[138] This suggests a need to allow firms to choose their ethical regimes. On the other hand, firms probably would not face serious complications in monitoring for violations of basic, and therefore largely uniform, state duties of competence and diligence. Moreover, ethical rules concerning duties connected with litigation probably have to be uniform within each forum, thereby precluding firm choice as to that set of rules.

A more limited alternative to a completely firm-based system would be to continue to license lawyers in, and subject them to the rules of, particular states but let them practice outside those states at branches of licensed firms. This would be similar in effect to the system that now operates in some states for in-house corporate counsel.[139] It

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[136] *See* Erin A. O'Hara, *Opting Out of Regulation: A Public Choice Analysis of Contrctual Choice of Law,* 53 VAND. L. REV. (2000) (arguing that enforcing jurisdictional choice, by mitigating the effect of an enacted law, reduces interest groups' costs and benefits, and therefore may either deter or encourage enactment).

[137] The availability of jurisdictional choice therefore might evolve in a way that offers beneficial variety for different types of firms. *See supra* §II(A)(3).

[138] *See supra* §I(F).

[139] *See supra* text accompanying note 128.

therefore appropriately reconciles rules dealing with these similar contexts and clarifies application of the rules on unauthorized practice of law.

Either type of firm-based choice of regime presents a problem in terms of attenuating the relationship between lawyers and particular states' laws. State-based licensing and ethical rules can be defended as efficient barriers to entry that encourage lawyers to work on laws of states in which they are licensed by reducing free-riding on these efforts.[140] In other words, by capitalizing the value of a state's law into the value of its lawyer licenses, the state-based system can give lawyers an incentive to maximize the social value of their state's laws. A firm-based choice system undercuts this incentive by detaching individual lawyers from states' laws. To be sure, since the firms themselves in effect control lawyers' time by developing incentive systems, firm-based choice might be said to encourage firms to efficiently invest their lawyers' time in making law improvements. At the same time, however, letting multi-state firms shop for ethics rules among the various states in which they have branches may reduce their commitments to, and incentives to improve, the law of any particular state.

A third approach to firm-based licensing would be to allow large multi-state law firms to opt out of ethical regulation. A justification for this approach is that a firm's incentive to maintain its reputation,[141] and therefore to monitor its lawyers, eliminates the need for monitoring through ethical rules and state enforcement agencies. Indeed, this approach could help protect clients to the extent that ethical rules actually impede law firms from developing reputational bonding mechanisms.[142] In other words, ethical rules and law firms are to some extent substitutes rather than complements. Because only the largest law firms with the most substantial reputations can be relied on to perform this function, comprehensive law firm licensing and choice of regime arguably should replace lawyer licensing only for the largest firms.

A variation on the third alternative would preserve a separate category of ethical rules and state monitoring for law firms that opt out of the standard regime, thereby ensuring minimal protection for clients. This back-up regime might be a very general set of standards, with decisions left to individual firms how best to meet these standards. Permitting jurisdictional choice might facilitate this kind of differentiation between large-firm and small-firm ethical regimes.[143]

B. CHOICE OF LAW FOR LAWYERS

There is a further set of issues as to whether jurisdictional choice should be recognized not only for law firms, but also for individual lawyers.[144] Practice by

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[140] *See* Larry E. Ribstein, *Lawyer Licensing and State Law Efficiency* (2001) previously *Lawyers' Property Rights in State Law*, http://papers.ssrn.com/paper.taf?abstract_id=251750, George Mason Law & Economics Working Paper No. 00-43 (2000).

[141] *See supra* text accompanying note 7.

[142] *See* Ribstein, *supra* note 7.

[143] *See supra* §I(A)(3).

[144] Firms obviously would want to compel individual lawyers in the firm to agree to adhere to the same set of rules. Thus, this approach in effect would apply mainly to lawyers who are not affiliated with

individual lawyers may involve problems of multi-jurisdictional regulation similar to those for firms to the extent that lawyers practice on a nationwide basis through the Internet or by representing multi-jurisdictional clients. Moreover, permitting jurisdictional choice by individual lawyers has the same advantages as for firms in terms of facilitating jurisdictional competition, experimentation and variation.

There are, however, two significant difficulties with permitting broad jurisdictional choice by individual lawyers. First, as discussed above, there is a problem with detaching lawyers from particular states and thereby weakening their incentives to maintain state law. Second, and more importantly, race-to-the-bottom arguments have more traction regarding this broader proposal than for the more limited proposal concerning law firm choice. As discussed above,[145] choice of law by multi-jurisdictional law firms is disciplined by law firms' incentives to maintain their reputations and by the many sophisticated actors in these firms' product markets. Regime choice by individual lawyers who are not in large firms is not likely to be similarly disciplined.

V. CONCLUDING REMARKS

This article has presented a limited proposal for permitting choice of structural ethical regulation by multi-jurisdictional law firms. The proposal is intended to deal with the most serious problems of applying varying state laws to these firms without incurring the even more substantial costs of a federal regime. The proposal would facilitate competition, experimentation and variation in ethical rules by effectively preventing individual states from imposing their structural rules on multi-jurisdictional firms.

Some of the same considerations that justify limited jurisdictional choice by law firms might also justify more general jurisdictional choice by law firms and individual lawyers. However, as discussed in Part IV, any move toward a broader jurisdictional choice regime should be made with care, particularly in view of the potential effects of such a move on lawyers' incentives to participate in state lawmaking and possible race-to-the-bottom concerns.

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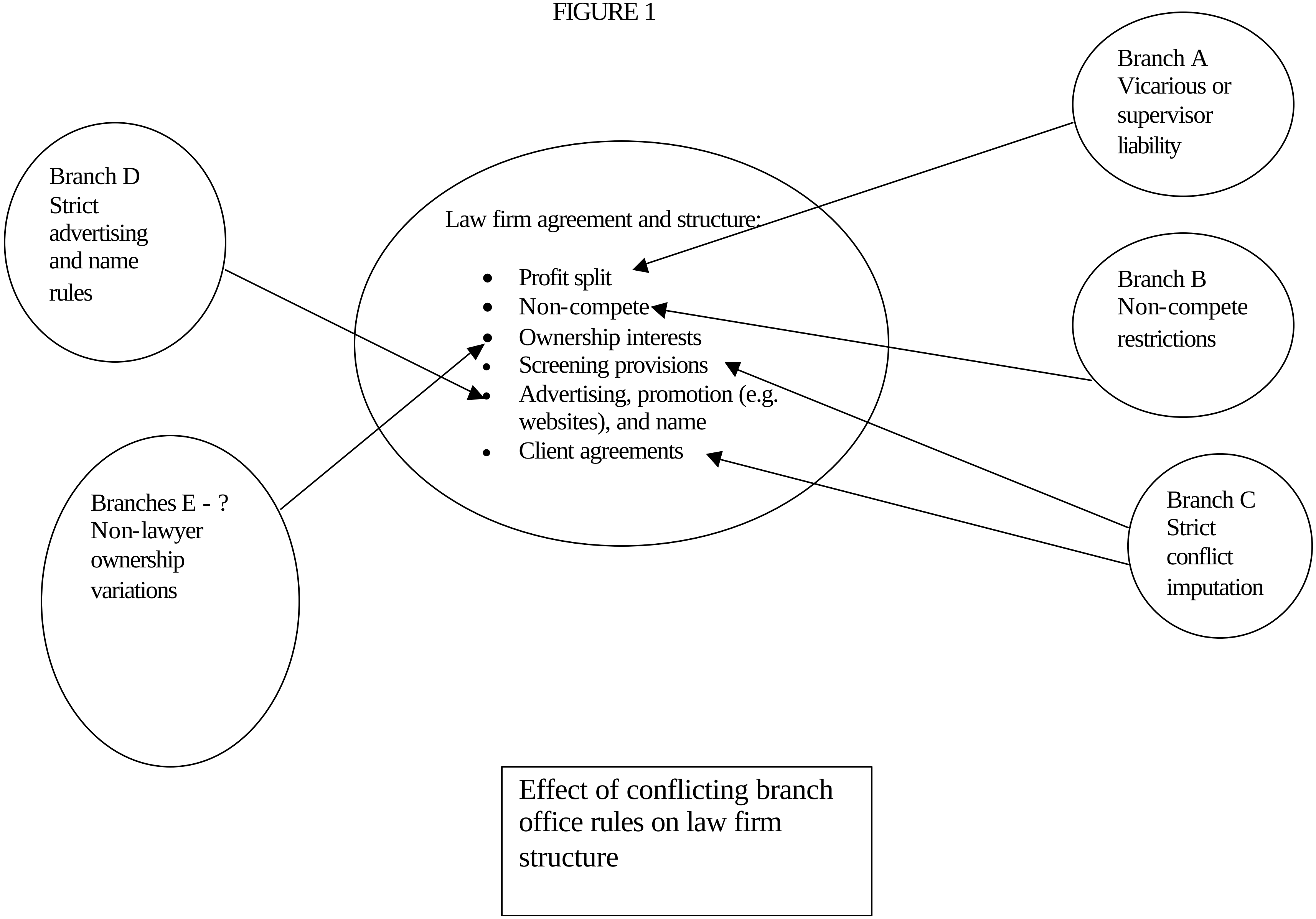
firms.

[145] *See supra* §II(B)(2)-(3).

FIGURE 1


Branch A
Vicarious or supervisor liability
Branch D
Strict advertising and name rules
Law firm agreement and structure:
Profit split
Non-compete
Ownership interests
Screening provisions
Advertising, promotion (e.g. websites), and name
Client agreements
Branch B
Non-compete restrictions
Branches E - ?
Non-lawyer ownership variations
Branch C
Strict conflict imputation
Effect of conflicting branch office rules on law firm structure