STRUCTURAL CONFLICTS OF INTEREST: HOW A LAW FIRM'S COMPENSATION SYSTEM AFFECTS ITS ABILITY TO SERVE CLIENTS

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While much information pertaining to the earnings and financial affairs of law firms is routinely publicly disclosed, information regarding a firm's compensation system or the tenure of its partners is not generally released. Mr. Bernstein's article suggests that clients should seek this information because it directly affects a lawyer's incentives to act in a client's best interest. Moreover, the author suggests that Model Rule 1.7 may, under certain circumstances, require the disclosure to clients of partnership compensation arrangements, but that the Rule should speak to the issue with greater clarity.

The author discusses the relationship between law firm compensation systems and partner incentives to serve the firm's clients and points out that the so-called eat what you kill system of partner compensation may give rise to conflicts of interest within the meaning of Rule 1.7 by depriving the partner of the benefit of the firm's client diversification. The author illustrates his point by describing one of the circumstances in which a partner who does not have the benefit of such diversification will have an incentive to act contrary to the best interest of the client in the course of rendering advice concerning the sale of a business.

The author concludes with a suggestion that perhaps the American Bar Association should consider a rule requiring that law firms disclose their partner compensation systems to their clients.

Law firms routinely disclose a great deal of information about their financial affairs but they rarely disclose information about partnership

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profit allocations or the tenure of their partners.[1] This article suggests that clients would be well advised to seek this information because it often bears upon the incentives of individual lawyers to act in the best interests of the firm's clients. It also suggests that Rule 1.7 of the American Bar Association (ABA) Model Rules of Professional Conduct (Model Rules) pertaining to lawyers' conflicts of interest may, under certain circumstances, require disclosure of partnership compensation arrangements and concludes that given the potential for conflicts of interest identified in this article, the Code should speak to this issue with greater clarity.

Law firms typically structure their partner compensation systems to create incentives for partners to behave in ways that the firm regards as desirable from its internal perspective. The two most common systems are the "eat what you kill system" and the "lockstep system," each of which creates both desirable and undesirable incentives.[2] Under an "eat what you kill system," which rewards current contributions to firm profits and/or punishes short-term reductions in such contributions,[3] shirking is deterred, but at the same time, each partner is deprived of the benefits of the firm's client base diversification.[4] Conversely, under a "lockstep system" in which partners are rewarded based primarily upon length of service,[5] partners obtain the benefits of a diversified client base, but shirking is not fully deterred.[6] The literature pertaining to partnership compensation systems has considered these and other intrafirm incentive effects associated with these two compensation systems, as well as how the systems benefit a firm's partners, but has almost completely ignored the effects of this choice on the firm's clients. More specifically, the literature has failed to consider the ways that the type of legal advice given to clients by law firm partners is likely to differ depending on whether the partner rendering advice does or does not have the benefit of his firm's diversified client base.

Part I discusses some of the theoretical consequences of the two basic compensation systems with an emphasis on how they impact a partner's ability to take advantage of the firm's diversified client base and the effects of diversification upon partner incentives to act in the best interest of the client. Part I also addresses the question of how in certain con-

1. The American Lawyer customarily reports the gross revenues, profits, profits per partner, and the average compensation per partner of most major law firms. *See, e.g.*, American Lawyer Media, ALM LLC, *America's Highest-Grossing Law Firms in 2001*, AM. LAW., July 2002, at 203.

2. Law firm compensation systems vary considerably but usually reflect one of these two basic approaches to a significant degree.

3. Called the "eat what you kill system" by its opponents and the "merit system" by its supporters.

4. Ronald J. Gilson & Robert H. Mnookin, *Sharing Among the Human Capitalists: An Economic Inquiry into the Corporate Law Firm and How Partners Split Profits*, 37 STAN. L. REV. 313, 352 (1985).

5. Called the "lockstep system" by its opponents and the "seniority system" by its supporters.

6. Gilson & Mnookin, *supra* note 4, at 345.

texts, the "eat what you kill system," by reducing the benefits to partners of their firm's client diversification, may create incentives that result in conflicts of interest that probably come within Rule 1.7 of the Model Rules. Part II gives a real world example of some of the theoretical principles discussed in part I by examining the pressures on a law firm partner advising a client with respect to risk allocation provisions of a contract to sell a business. Part II also considers how, in the context of such a transaction, a partner without the benefit of his firm's client diversification may have an incentive not to act in the best interest of the client because of his fear of losing the client if a negative outcome follows his action. Part III concludes with some observations as to how law firms, clients, and the ABA might deal with the potential effects upon clients of partnership compensation systems. It suggests that the ABA might well consider requiring that law firms disclose their compensation systems to all of their clients.

PART I

From a client's perspective, the significant difference between the "eat what you kill" and "lock step" compensation systems is that the former, by depriving each partner of the benefit of the firm's client diversification, increases the loss a partner will suffer if a client is lost and his incentive to avoid that loss. A heightened fear of losing a client may have certain intended beneficial effects on the lawyer/client relationship, but it also may create a conflict between the interests of the lawyer and the client.[7] A partner with a great deal to lose if the client goes elsewhere will undoubtedly be highly motivated to answer phone calls, deliver work product promptly, and work diligently. Similarly, he may be motivated to issue appropriate opinions of counsel to third parties on matters such as "true sale" and "perfection of security interests" even though by doing so, he may be exposing the law firm to potential liability or to the cost of defending against invalid claims.[8] These consequences of the "eat what you kill" compensation system increase client satisfaction and are beneficial to the client and the law firm.

However, the benefits come at a price. In many contexts, a partner with a significant fear of losing a client may have more to lose (or less to gain) personally by acting in the best interest of the client than by acting otherwise because he will bear most of the burden of losing the client,

7. In order to simplify matters, the discussion that follows assumes a law firm with diversified practice acting through its partners. It also assumes that the client is an entity that acts through an employee or other agent.

8. Much legal advice given by lawyers addresses matters that are not entirely clear and courts often act in unpredictable ways. As a result, there is often a risk that advice that was proper at the time given may be ultimately adjudged to be wrong. The risk that this may result in liability or the cost of successfully defending against an invalid claim is an unavoidable cost of issuing opinions to clients and sometimes induces lawyers to be overly conservative in rendering such opinions.

whereas any reputational benefit to the firm from his acting properly and any potential malpractice liability will be shared with all partners. In such situations, there is a conflict between the personal interest of the partner and his client that may be detrimental to the interests of the client and the law firm.[9] There are many examples of this type of conflict. The long-term interests of the client may require advice that exposes the client to a risk of an immediate negative consequence for which the partner may be held accountable. The partner's fear may provide an incentive to render overly aggressive advice (such as whether a transaction involves a "true sale") when, in fact, the transaction will expose the client to potential loss and the law firm to liability, if the opinion will please an agent of the client who himself has an interest that conflicts with that of the client and controls the selection of counsel.[10] The same fear may motivate the partner to render overly cautious advice to avoid future criticism if he is not under pressure to be optimistic.

The Model Rules prohibit representation if there is "a significant risk that the representation of one or more clients will be materially limited by . . . a personal interest of the lawyer" unless the written "informed consent" of the client is obtained.[11] Although the comments to

9. Commentators have suggested that the fear of being second-guessed can often induce lawyers to give less than optimal advice. *See* Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347, 354 (1996) (dealing with the use of suboptimal standard clauses); Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375, 423 (1997) (explaining why lawyers often give excessively conservative substantive advice and noting that lawyers with a diversified portfolio of clients have less of incentive to do so than nondiversified lawyers).

10. This often occurs when the client's agent, such as an investment banker, has the power to select counsel and will earn a contingent fee only if a transaction is completed.

When "independent" accountants, underwriters, and other third parties rely on the advice, the conflict raises public policy issues that are not considered in this paper. It is, however, not possible to resist suggesting that as the investigations of the Enron situation proceeds, the diversification of the law and accounting firms involved will be relevant. Enron allegedly represented about seven percent of the revenues of its law firm but less than one percent of the revenues of Arthur Andersen. Hopefully, the investigators will examine the extent to which the status and compensation of the Arthur Andersen partner in charge of the Enron account would have changed if Enron had changed accounting firms.

11. Rule 1.7 provides as follows:

> (a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if
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> (1) the representation of one client will be directly adverse to another client; or
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> (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client, or a third person, *or by a personal interest of the lawyer*.
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> (b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if each affected client gives informed consent, confirmed in writing, and
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> (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
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> (2) the representation is not prohibited by law; and
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> (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal.

MODEL RULES OF PROF'L CONDUCT R. 1.7 (2002) (emphasis added). The following are excerpts from some of the Committee's Commentary to Rule 1.7:

the Model Rules do not address the issue specifically, it can be argued that the plain meaning of Rule 1.7 covers a partner's interest in his law firm and that if the structure of that interest "materially limits" his ability to represent the client, the client's informed consent should be required. No such consent would be "informed" without disclosure of a law firm's partnership compensation system. The fact that this information is rarely disclosed to clients is not an accident and the suggestion that it be disclosed will undoubtedly be met with opposition by law firms.[12] However, if the structure of partnership compensation systems has a powerful impact on lawyer incentives, the issue of disclosure should be considered along with more obvious types of conflicts of interest by those seeking to regulate the ethics of lawyers. If a lawyer has an ownership interest in a corporation seeking to purchase property from a client, the lawyer's interest conflicts with that of the client. Such a conflict is indistinguishable from a conflict between a lawyer's personal interest in his law firm and the interests of a client purchasing services from the firm. Although it is more difficult to determine whether the conflict of interest exists in the latter case, there is no reason for treating the conflict differently when it does exist.

> [1] Loyalty and independent judgment are essential elements in the lawyer's relationship to a client. Concurrent conflicts of interest can arise from the lawyer's responsibilities to another client, a former client, or a third person or from the lawyer's own interests. For specific rules regarding certain concurrent conflicts of interest, see Rule 1.8. For former client conflicts of interest, see Rule 1.9. For conflicts of interest involving prospective clients, see Rule 1.18. For definitions of "informed consent" and "confirmed in writing," see Rule 1.0(b) and (e).
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> [2] Resolution of a conflict of interest problem under this Rule requires the lawyer to: 1) clearly identify the client or clients; 2) determine whether a conflict of interest exists; 3) decide whether the representation may be undertaken despite the existence of a conflict, i.e., whether the conflict is consentable; and 4) if so, consult with the clients affected under paragraph (a) and obtain their informed consent, confirmed in writing. The clients affected under paragraph (a) include both of the clients referred to in paragraph (a)(1) and the one or more clients whose representation might be materially limited under paragraph (a)(2).
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> [10] The lawyer's own interests should not be permitted to have an adverse effect on representation of a client. For example, if the probity of a lawyer's own conduct in a transaction is in serious question, it may be difficult or impossible for the lawyer to give a client detached advice. Similarly, a lawyer may not allow related business interests to affect representation, for example, by referring clients to an enterprise in which the lawyer has an undisclosed financial interest. . . .
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> [18] Informed consent requires that each affected client be aware of the relevant circumstances and of the material and reasonably foreseeable ways that the conflict could have adverse effects on the interests of that client. See Rule 1.0(e) (informed consent). The information required depends on the nature of the conflict and the nature of the risks involved. When representation of multiple clients in a single matter is undertaken, the information must include the implications of the common representation, including possible effects on loyalty, confidentiality and the attorney-client privilege and the advantages and risks involved. See Comments [30] and [31] (effect of common representation on confidentiality).

Id. R. 1.7 cmts. 1–2, 10, 18.

12. One reason the information is not generally disclosed may be that firms wish to clothe partners with the prestige of partnership so as to enhance their status with clients (and their billing rates) when some partners may be "contract partners" or simply employees. Another reason may be that firms do not want their client to know of the potential conflict of interest discussed in this article.

PART II

Both the importance and complexity of the structural conflict of interest created by an excessive fear of losing the client being served are illuminated by an examination of the pressures upon a partner in a law firm advising an employee (the CEN) as to a risk allocation provision of a contract to sell a client's business. The example demonstrates how a law firm that passes a diversified client base through to its partners will be in a better position to help a client overcome certain agency problems of its CEN and to otherwise advise a client than will a firm or partner which is not diversified.

A. The CEN's Second Guess Risk

The CEN has an agency problem flowing from the fact that like any agent he may be second-guessed and punished if his actions, even if appropriate when taken, are followed by a negative outcome.[13] I call the risk of ex post criticism the "Second Guess Risk." This risk often imposes personal costs (Second Guess Costs or SGCs) on an agent that can be reduced if he acts contrary to the best interest of his principal either by electing an inappropriate course of action or by imposing unnecessary negotiation costs upon his principal. If at the time the action is taken, a negative outcome is possible, then an agent will incur SGCs equal to the damage he will incur personally if he is second-guessed, multiplied by the probability that this will occur.[14] If his SGCs of acting in the best interest of his principal are greater than those of "misbehaving" by acting otherwise, the differential is a cost (Service Cost) he will bear personally if he acts in the best interest of his principal. The analysis in this article assumes that an agent will act contrary to the best interests of his principal only if his Service Cost exceeds a certain level in excess of zero (Defection Point).[15]

13. Common experience indicates that second-guessing is ubiquitous in business as well as in the home. It is most prevalent when an action is evaluated on the basis of its outcome rather than the quality of the action. *See* Kahan & Klausner, *supra* note 9, at 357; Jeffrey Zwiebel, *Corporate Conservatism and Relative Compensation*, 103 J. POL. ECON. 1, 15 (1995).

Studies suggest that even when a third party can evaluate the action without regard to outcome, his judgment is often nevertheless biased by knowledge of the outcome. This "hindsight bias" is the cognitive tendency to "attach an excessively high probability to an event simply because it ended up occurring." Christine Jolls, Cass R. Sunstein, & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1523 (1998); *see also* Jeffrey Rachlinski, *A Positive Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571 (1998). Second-guessing may also be caused by other factors such as an evaluator who is an agent of the principal and who has an incentive to find someone to blame.

14. SGCs should be distinguished from "agency costs" as that term is generally employed. Agency costs are costs that are borne by a principal as a result of an agency problem of its agent. SGCs are costs that are borne by the agent and may cause him to act in a way that will result in agency costs to the principal.

15. This assumption varies from that usually made in the law and economics literature concerning human behavior. That literature usually assumes for the purposes of analysis that people will sim-

The SGCs of an agent acting in the best interest of his client are equal to (i) the present value of the damage he will suffer if a negative outcome occurs, multiplied by the probability of such an outcome, less (ii) the present value of any benefit he may derive from acting properly. The SGCs of an agent not acting in the best interest of his principal are equal to (i) the present value of the damage he will suffer if a negative outcome occurs multiplied, by the probability of such an outcome, plus (ii) the present value of the damage he will suffer if the principal discovers he is misbehaving, multiplied by the probability that he will be discovered misbehaving.[16]

The Second Guess Risk often creates a conflict between the interests of a principal and those of an agent negotiating a transaction on his behalf in large part because the consequences to the agent of a positive and negative outcome are often asymmetrical—the damage he will suffer if there is a negative outcome will exceed the benefit he will derive from a positive outcome.[17] An employee may lose his job or a lawyer may lose the client if there is a negative outcome, whereas a positive outcome will usually provide a relatively modest benefit because it is expected, particularly when the agent is negotiating terms of a transaction after the principal has agreed to a price. Even if the payoffs are equivalent in nominal terms, normal loss aversion may create the asymmetry.[18] This asymmetry often results in a Service Cost that provides the negotiator with an incentive to focus upon the probability and timing of a negative outcome and the probability of discovery if he misbehaves, rather than to consider the expected value to his principal of alternative courses of action. The effect of this asymmetry is often magnified by a low probability that misbehavior will be discovered in the absence of a negative outcome.

ply act to their own financial best interest no matter how small the benefit. Jolls, Sunstein & Thaler, *supra* note 13. There is some empirical evidence that this assumption of "unbounded self-interest," though useful in certain contexts, does not accurately reflect the way in which people actually behave. The concept adopted in the assumption underlying this article is referred to in the literature as "bounded self-interest." *Id*. at 1479. Although the empirical evidence referred to consists of experiments in contexts that differ significantly from those of a negotiated commercial transaction and is therefore suggestive rather than persuasive, I adopt the concept not because of the evidence but because it is consistent with my own experience. Every man may indeed have a price or Defection Point, but it is rarely a peppercorn. The level of the Defection Point will depend upon many factors, including the personality and upbringing of the agent, his concern for his reputation, and whether he believes his principal has treated him fairly in the past—it may range from de minimis to substantial to infinity. Part of the job of managing the relationship between a principal and agent is to understand the Defection Point of the agent and to act in a way that will maximize the Defection Point. This article does not address the issue of how to accomplish this goal.

16. The agent's damage if he is discovered misbehaving will include the resulting general reputational effect, as well as the loss of future revenue from his principal.

17. *Cf.* Kahan & Klausner, *supra* note 9, at 354–55.

18. *See* Jolls, Sunstein & Thaler, *supra* note 13, at 1484.

B. Dealing with the Second Guess Risk

In the context of making recommendations concerning the risk allocation provisions of a contract to sell a business, a CEN has good reason to fear being second-guessed if there is a negative outcome because it will be difficult for him to justify his recommendations ex post and the damage he will suffer if he is second guessed will be substantial. Consider the pressures on a CEN acting on behalf of a risk-neutral seller of a business who has been asked to make a common representation to the effect that the business has no undisclosed tax liabilities. Assume that if the seller represents without qualification that there are no undisclosed tax liabilities, the value of the transaction to the buyer will be increased and the seller will be adequately compensated for making the representation.[19] Whatever action is taken, the risk of a negative consequence cannot be avoided. If the seller makes the representation, the contingency (the existence of a tax liability) may occur after the contract is signed and the CEN may be fired if he cannot demonstrate to his employer that adequate consideration for the representation was received.[20] On the other hand, if the seller refuses to make the representation, another negative consequence may occur—Transaction Breakdown—and he may be fired if he cannot demonstrate that the refusal to make the representation was in the best interest of the seller at the time.[21]

Either decision by the CEN concerning the tax representation will have been based upon the view that is taken by the CEN of the value of the representation to the buyer. That value may have been the result of a variety of factors, including the buyer's risk aversion, the CEN's experience in other transactions, or agency problems of a negotiator. The buyer's position may also have been based upon his view, based upon custom or other criteria, that the seller will ultimately make the represen-

19. The seller usually has greater knowledge concerning the existence of tax liabilities and, therefore, the seller's cost of making the representation is often lower than its value to the buyer, who, in the absence of information, must assume the worst. The seller should be in a position to make the representation and charge more than its expected cost, but less than its value to the buyer—a so-called win-win solution.

20. Although the seller's cost of making the representation may be lower than its value to the buyer, it is not zero because the seller can rarely be certain that there are no tax liabilities. Even if the seller represents only that he "has no knowledge" of any such liabilities, it is difficult to establish a lack of knowledge and the seller therefore assumes the risk that the buyer may falsely claim breach, thereby subjecting the seller to liability if it should lose as the result of judicial error, and litigation costs even if it wins. *See* Edward A. Bernstein, *Law & Economics and the Structure of Value Adding Contracts: A Contract Lawyer's View of the Law & Economics Literature*, 74 OR. L. REV. 189 (1995).

21. Although a provision specifically addressing risk allocation is perhaps the most obvious example of how the Second Guess Risk operates, similar problems are inherent in most drafting decisions. A decision to use incomplete language rather than incur the cost of seeking a state contingent clause involves similar considerations. For example, a provision permitting termination of a contract to sell a business if a "material adverse change in the business" occurs prior to the closing imposes on the seller's negotiator the risk of ex post criticism if a court holds that the transaction can be terminated for reasons that the seller does not consider material. On the other hand, the agent may be criticized if transaction breakdown occurs or high negotiation costs are incurred because of an attempt to achieve state contingent perfection.

tation if enough pressure is applied. At the end of the day, evaluation of the risk of transaction breakdown is based on a judgment about the state of mind of another and is not verifiable.[22] Finally, the CEN's refusal to make the representation may have been made for tactical reasons, such as a desire to indicate a strong bargaining position at the beginning of negotiations, which are often impossible to demonstrate.[23] Similar problems are presented when the CEN must demonstrate, ex post, the value received for making the representation. In order to establish the value of any consideration received, it is often necessary to reconstruct a complex trading pattern, a difficult task when, as is often the case, the consideration is in the form of concessions on one or more other disputed clauses.[24]

The same example illustrates the asymmetry of the CEN's payoff for a positive and negative outcome. If the representation is made and there are in fact no undisclosed tax liabilities, the fact that the seller received consideration for making the representation or that transaction breakdown was avoided is likely to go unnoticed.[25] Similarly, the seller is not likely to notice if the representation is not made or is limited and the transaction is consummated. In either case, the most the CEN can hope for is credit for having achieved an expected result. However, a negative outcome such as transaction breakdown or significant payment to the buyer on account of an undisclosed liability is not likely to go unnoticed and may lead to second-guessing of the CEN and a risk to his continued employment or future promotion. As a result, the CEN will often have an incentive to base his decision upon the probability or timing of the event that a negative outcome will occur, even if the alternate course of

22. In the context of a negotiating decision, the negotiator's action is verifiable when it is worthwhile (and possible) for the agent to demonstrate to his superior that an action was appropriate. *See* Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEGAL STUD. 271 (1992). Negotiators, like poker players, usually operate without complete information and often elect to fold a hand (agree to make the representation) or call (refuse to make the representation) without knowing whether the opponent will terminate negotiations if the representation is not made.

23. It is difficult, though not impossible, to reduce the CEN's fear of being second-guessed by means of internal corporate policies. The employee's fear may result from factors other than experience with the employer. Moreover, evaluation of a negotiator requires subjective judgment and is inherently subject to error because, as noted above, the negotiating context is difficult to recall or explain ex post. Most importantly, a modest reduction of the employee's estimate of the probability of being second-guessed will probably not have a meaningful effect upon his incentive to misbehave because the consequences of being second-guessed are severe—the loss of a job or a reduced opportunity for advancement. Any attempt to reassure an employee that he will not be second-guessed by adopting a policy of withholding valid criticism may reduce the employee's SGCs, but it will also interfere with normal performance evaluation. The CEN's fear of being second-guessed may be reduced, at least with respect to standard contractual issues such as a tax representation, if he reports to a senior manager with M&A experience, such as in-house general counsel. Such a manager will be in a better position than others to understand the reasoning behind a negotiation. The senior manager will also have agency problems since the fear of second-guessing is usually felt at all but the highest levels, but they may be manageable if he has sufficient tenure.

24. For the same reasons there is a low probability that misbehavior will be discovered in the absence of a negative outcome.

25. *See* Kahan & Klausner, *supra* note 9, at 354–55.

action will have a higher expected value to his employer. Assume, for example, that there is a ten percent chance that the representation will result in a liability of $1 million (expected cost of $100,000) and a five percent chance that a refusal to make the representation will lose the transaction and a $3 million profit (expected cost of $150,000). The CEN might refuse to make the representation because it had a lower probability of a negative outcome and because a negative outcome would be immediate even though that course of action was not in his employer's best interest unless the probability of being discovered misbehaving was sufficient to dissuade him.

C. The Outside Law Firm

The CEN's fear of being second-guessed (and therefore his SGCs) can be substantially reduced by inviting his employer to blame an outside law firm if a decision results in an negative outcome.[26] The CEN has a good defense to criticism—"the lawyer agreed that it was appropriate to make the representation"—and he should be free to act in the best interest of his employer. Law firms often provide added value to their clients by consciously putting themselves in a position to be blamed if a negative outcome results from the action taken.[27]

A number of conditions must be met in order to shift responsibility to the law firm. First, the law firm must act as a risk evaluator and make substantive recommendations.[28] Second, the employer's general counsel

26. Outside counsel is often retained to handle transactions with which the in-house staff of the client does not have experience, such as M&A transactions. In such situations, the variable cost of having the firm perform the function suggested here is low; when outside counsel would not otherwise have been retained, the variable cost is higher.

27. Few practitioners will dispute that it is common practice for lawyers to provide this service; they call it helping the client's CEN "cover his ass." I avoid the use of this term in the body of this article not as a matter of taste, but because it is most often used pejoratively. I view the service as a normal function of a law firm that increases the well-being of its clients, and is one of the reasons that law firms are able to charge substantial fees even in transactions that seem substantively mundane.

28. The alternative to functioning as a risk evaluator is to function as a risk identifier. A risk identifier simply identifies risk and drafts language that reflects the agreement of the parties. *See* Langevoort & Rasmussen, *supra* note 9, at 413. With respect to a representation (and the related indemnity) as to taxes, for example, a risk identifier would point out that if the representation is made and there are undisclosed tax liabilities, the seller would be responsible for them. A risk evaluator might advise that because sellers generally make such representations, a refusal to make the representation might significantly increase the risk of transaction breakdown or create a negotiating atmosphere that will make it difficult to achieve the client's goals with respect to other provisions. He might also point out that since the seller has more information concerning unknown tax liabilities it might be in a position to profit by making the representation. *See supra* note 19. This advice would be coupled with a recommendation that the representation should be made unless there are specific problems that must be dealt with. Similarly, when considering whether to continue negotiating for greater specificity in an incomplete provision, a risk evaluator may advise that although there are some risks to the language as is, it is not worth the effort to try to add more specificity, whereas a risk identifier would note the risk of incomplete language and let the client decide when to continue negotiating for greater specificity. Risk identification has a value, but it is much less than the value of risk evaluation. Although the example focuses on the function of the firm in dealing with a CEN's agency problem in the context of a risk allocation decision, the analysis presented in this article applies to any situation in

must have approved the firm or, if the CEN has selected it, the firm must have a reputation such that the employee will not be second-guessed for relying on its advice. Third, at the time he acts, the CEN must be confident that if there is a negative outcome he will be in a position, ex post, to demonstrate to his superior that he in fact relied upon the firm in making the decision. A law firm can cause this condition to be satisfied by putting its recommendation in writing, by making it in the presence of the CEN's superior, or by developing a reputation for honestly confirming that a recommendation was made when an outcome is negative. Fourth, the position adopted must not be clearly erroneous. The protection provided to the CEN by third party advice has limits. In most circumstances, the CEN will be charged with at least checking with general counsel if the advice should have been seen to be clearly erroneous.[29] Finally, the firm must either agree with the CEN's conclusions or confirm that they are reasonable.

This final requirement means that the law firm assuming the Second Guess Risk will have a significant impact upon the decision-making process. The SGCs of a CEN will be increased if the law firm does not believe that his decision was correct or reasonable.[30] A disagreement that results from misbehavior by the CEN will benefit the client because it will discourage such behavior. However, a disagreement resulting from misbehavior by the firm will harm the client because such a disagreement will increase the probability that the employee will be second-guessed for acting in his employer's best interest and discourage proper behavior by the employee.[31] It is therefore important to maximize the

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which a law firm can add value to the transaction by making substantive recommendations for which it may be held responsible if there is a negative outcome.

29. The role of the outside law firm is often complicated when resolution of an issue depends upon a judgment that the firm is not qualified to make. For example, a decision as to the probability that a seller has unknown tax liabilities is one that most firms will not be qualified to make without factual input from the client. The employee will probably discuss this with others in the organization who will therefore share responsibility for this judgment. While it is true that the CEN can be criticized for erroneously concluding that the probability of an unknown tax liability was low, the lawyer's advice that the transaction might be endangered if an expected representation is not given, together with the fact that others shared responsibility for the employee's conclusion, should reduce the employee's SGCs considerably.

30. This is one of the reasons it often appears that counsel, rather than the client, is controlling the transaction. However, this is not the objective that the client is trying to achieve. The purpose of asking the firm to make a recommendation is not to substitute its judgment for that of the employee, but to enable the employee to make a decision free of the effect of the Second Guess Risk. The CEN knows more than the lawyers about the capacity and goals of his employer and, after receiving advice from counsel as to the matters within its expertise, is therefore generally more qualified than outside counsel to make final decisions on substantive matters, as well as risk allocation.

31. An agent may misbehave because of agency problems other than the Second Guess Risk. Consider for example, an employee/negotiator who expects to receive a large bonus if a transaction is consummated. If the bonus is large enough, then the expected cost to the employee of the risk of discharge due to a future contingency may be modest in comparison to the expected cost of the risk that he will not get the bonus if the transaction is not completed. Under these circumstances, the employee agent will be motivated to cause his employer to assume the risk of such contingencies, if refusing to do so might pose a risk to his bonus even though he will be subject to the Second Guess Risk. An incidental benefit of retaining an outside law firm is that such misbehavior by the employee should be

incentive of the law firm and the lawyers actually rendering advice to behave properly. If the lawyer misbehaves, the client will be worse off than if the firm had not been retained.[32]

A law firm is itself an agent and will therefore have agency issues vis-à-vis its client. If it assumes the Second Guess Risk, it will incur SGCs at the time it makes its recommendation. It may lose a client if there is a negative outcome and it is second-guessed or if it is discovered misbehaving. However, the fact that the firm is diversified will substantially lower the importance of lost revenue from the departing client, whether it departs because the firm is second-guessed or misbehaves, and the primary concern of the firm will be to maintain its reputation as a risk evaluator that assumes the Second Guess Risk and acts in the best interest of its client since it charges a premium fee for that service.[33] This re-

deterred by the potential disagreement with the advice of counsel if he anticipates that the firm will act in the best interest of his employer. It is important, however, that the relationship with the firm is controlled by the employer's general counsel. If the employee controls the relationship, the firm will have a motive to confirm such misbehavior by the employee.

32. Even when lawyers ultimately make decisions that are in the best interest of the client, they often do so in ways that damage the client in other ways. *See* Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239 (1984). After demonstrating that it is usually in the best interest of both a seller and a buyer for the seller to reduce information asymmetries and the cost of doing so, Gilson ponders why practice does not seem to follow reason:

> What remains puzzling, however, is the apparent failure by both business lawyers and clients to recognize that the negotiation of representations and warranties, at least from the perspective of information acquisition costs, presents the occasion for cooperative rather than distributive bargaining. Reducing the cost of acquiring information needed by either party makes both better off. Yet practitioners report that the negotiation of representations and warranties is the most time consuming aspect of the transaction: it is termed 'a nit-picker's delight, a forum for expending prodigious amounts of energy in debating the merits of what sometimes seem to be relatively insignificant items.'

Id. at 272. The hostile negotiations Gilson notes are of two basic types. They may be real: two lawyers fighting to the death over representations and warranties or working through the night to craft state contingent clauses covering remote contingencies. More often however, the negotiations are simply the result of the lawyers trying to have it both ways; they ultimately make the proper recommendations, but only after making a record of intensely trying to negotiate a contrary result. The lawyer will have protected the CEN from the Second Guess Risk, but will also have reduced his own SGCs by reducing the probability that he will be second-guessed. This type of misbehavior is rarely discouraged by clients because its effects are subtle. Consequently, hostile negotiations followed by sensible recommendations are not uncommon. Often, as between lawyers, the negotiation is no more than a kabuki dance in which both know where they will end up. In this circumstance, there is little risk of transaction breakdown as the result of the substantive recommendations of the lawyers. However, since the client is often not informed that his lawyers are negotiating simply to protect themselves, the hostile feeling developed by the employee negotiators may lead to transaction breakdown on other issues and, in any event, future dealings between the parties to the transaction are often adversely affected. *See* Bernstein, *supra* note 20, at 194–203. When both nonlawyer negotiators are experienced in the type of transaction being negotiated, they often know that the fierce negotiation is but a dance and accept the fact as a cost of obtaining protection against the Second Guess Risk. Under these circumstances, out-of-pocket transactions costs are increased, but no other substantive harm to the transaction results. However, this type of behavior probably contributes to the decline of the general status of lawyers in the eyes of businessmen. On the other hand, depending upon the circumstances, it can be argued that the kabuki dance may be the lowest-cost way for the lawyer to protect both the lawyer and the employee from the Second Guess Risk, particularly if the lawyer does not have the benefit of diversification.

33. If the firm does not in fact act as a risk evaluator or, in doing so, makes recommendations that are not in the best interest of its client, then it is likely that its ability to charge a premium fee for

putational capital is usually more important than the loss of the revenue from the departing client. It is an asset of the law firm that the partners, as a group at least, have incentive to protect by minimizing incidents of misbehavior by the firm's lawyers. It is the value of this asset that maximizes the firm's incentive to assume the Second Guess Risk and reduces the probability that it will incur a Service Cost in doing so when it acts in the best interest of the client.

D. The Law Firm Partner

However, the law firm acts through yet another agent—its partner. Under an "eat what you kill system," the benefit of the firm's diversification is not passed on to the partner actually rendering advice and his Service Cost will be comparable to that of the CEN rather than that of the law firm. This is because if he acts in the best interest of the client, he will bear most of the cost if there is a negative outcome and the client is lost, whereas any reputational benefit the firm derives from his actions must be shared with his partners.

Under a "lock step system," however, the interests of a law firm and its partner are closely aligned. Any reduction in firm revenue resulting from the departure of a client will be shared by all partners, and the partner servicing the lost client will retain his interest in the premium the firm charges because of its reputation.[34] Much has been written about the relative merits and defects of the two basic systems of motivating firm partners. It is not my intention to take a position as to which is the better on balance, save to suggest that whatever the benefits of the "eat what you kill system" and other motivational systems that shift risk to the partners, they come at a cost. The cost includes the creation of a potential conflict between the personal interest of the firm's partners and clients that, among other effects, reduces the value of the firm's services because acting in the best interest of a client exposes a partner to the risk of being second-guessed.[35]

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assuming the Second Guess Risk on behalf of its client will be impaired. Even if the client does not notice the misbehavior of his lawyer, the observations of other parties to the transaction and their counsel will inevitably circulate and affect the firm's reputation. This is particularly so with respect to a firm's behavior in large transactions where there are many parties and, therefore, many observers.

34. The partner's concern with the long-term interests of the law firm derives from his capital interest in the firm which exists only to the extent that he has the right to a share of firm profits, even at times when he has not produced his pro rata share of firm profits. Gilson and Mnookin have pointed out that such arrangements provide the benefits of diversification to the partners, but that they must be accompanied by other circumstances that will constrain partner shirking (not working hard), grabbing (demanding a higher share of earnings when he has contributed more than his pro rata share of earnings), and leaving (leaving the firm if his demands for a higher share are not met). *See* Gilson & Mnookin, *supra* note 4, at 330–38.

35. On occasion, senior associates are responsible for making recommendations to the client. These lawyers have special agency problems that are difficult, if not impossible, to ameliorate. If the associate is winning the "tournament of lawyers"—that is, he has a good chance to become a partner—his damage if he is second-guessed will be enormous. He will also have very short time horizons. His overriding principle will be that there be no negative outcome until he is made a partner. The associ-

PART III

This analysis of the impact of partnership compensation structures has normative implications for clients, law firms, and those seeking to set ethical standards for the legal profession. Few would argue against the proposition that in selecting an outside law firm, clients should consider the potential conflicts of interest of the firm and its lawyers, as well as the general reputation of the firm and the talent of the lawyers who will be assigned to its account. Clients should therefore seek information concerning the extent to which the law firm has a diversified practice and whether its partners have the benefit of such diversification. This requires that clients obtain information concerning the firm's partner compensation structure.

For the same reason, those seeking to set ethical standards for lawyers should recognize that the conflicts of interest created by the lack of a diversified practice, though subtle and not often discussed, are powerful and ubiquitous. They should therefore consider requiring some form of disclosure by law firms of their partner compensation systems. It is difficult to determine on a case-by-case basis when, and the extent to which, conflicts of interest resulting from a lack of client diversification exist, because the SGCs of any action cannot be determined with precision and often depend upon subjective factors. As a result, any determination as to whether the conflict exists will be subject to a significant risk of error. What can be said however, is that a diversified partner will have a lesser potential conflict of interest than will a nondiversified partner. This fact may well justify a requirement that all law firms disclose their partner compensation systems to clients as a matter of course.

Finally, law firms considering the type of compensation system that might best serve their needs should take into account the effect of the systems upon their ability to serve the needs of clients. More valuable service to clients generally means higher revenues and profits. Gilson and Mnookin point out that some of the most successful firms in the United States have a "lockstep system."[36] I suggest that one of the reasons for this is that these firms are better able to serve clients than firms with an "eat what you kill system," at least with respect to situations in which the fear of being the second-guessed might lead to suboptimal results.

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ate who is losing the tournament has the same motivational structure, since he wants to avoid a negative outcome until he has left the firm with affirmative recommendations. This does not mean that senior associates cannot cope with the Second Guess Risk, but merely that they must have a high Defection Point to do so.

36. Gilson & Mnookin, *supra* note 4, at 341.