

## LAWYERS AND COVENANTS NOT TO COMPETE

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### ABSTRACT

A historical look at the developments of covenants not to compete among lawyers and what lies ahead in the future.

This article will examine "Covenants Not To Compete" as they apply to attorney-partnership agreements. Covenants not to compete have always been viewed skeptically by the courts in any business contract. The courts have applied an even harsher rule on law firms that try to restrict lawyer movement among firms. Initially, this article reviews how these agreements are applied to general business contracts as compared to lawyers. Next, the article examines the historical development of the "Per Se Invalid" rule for noncompete clauses in lawyers' partnership agreements. Next come different theories as to why or why not the per se invalid rule should still be applied today and what alternatives exist. Finally, the outlook for the future of covenants not to compete in lawyer-partnership agreements is explored.

### AN OVERVIEW

Covenants not to compete are not a new development in the legal world. These types of clauses have appeared for centuries in the sale of business contracts, partnership agreements, and employment contracts. English courts generally found these types of covenants to be illegal restrictions on economic freedom until the sixteenth century. It was not until the eighteenth century that courts started to even consider enforcing these agreements, as they applied the first glimpse of what today is called the reasonable test [1].

Recent court decisions show courts will generally uphold covenants not to compete if the agreement is reasonably necessary to protect the employer's legitimate business interests and the restrictions themselves are not viewed as unreasonable. The courts must wrestle with two viewpoints: 1) public policy in the United States favors employee mobility and economic competition, versus 2) the concept that the employee owes his employer a duty of loyalty and confidentiality [2].

Although employers have won some victories in enforcing covenants not to compete in recent history, lawyers have not been so lucky. Attorneys have been singled out by the courts for special treatment when deciding whether to uphold these agreements. The courts' application of this higher standard comes from the *per se* invalid rule applied to covenants not to compete as adopted by legal ethic committees [3-5].

### HISTORICAL BACKGROUND

The *per se* ban on covenants not to compete first appeared in 1961, when the American Bar Association Committee on Ethics and Professional Responsibility addressed the subject in Formal Opinion 300 [3]. The committee came to the conclusion that although these types of agreements on their face appeared reasonable, the committee declared them a *per se* ethics violation. The committee based its conclusions on Canon 7 of the Canons of Professional Ethics, which states, "efforts, indirect or direct, in any way to encroach upon the business of another lawyer, are unworthy of those who should be brethren at the Bar" [6].

The American Bar Association committee gave three reasons as support for its decision. One, they said, clients are not like goods in a store. Therefore, an agreement that amounted to bartering in clients "would appear to be inconsistent with the best concepts of our professional status" [3]. The second reason was that a lawyer has the right to practice in any location s/he chooses. Finally, the ethical rules of the day prohibited a lawyer from soliciting another lawyer's clients; therefore, covenants not to compete were unnecessary [3]. Thus, the initial reasoning for the *per se* invalid rule was to protect the rights of lawyers.

A year later, the topic of covenants not to compete again was addressed by the committee. Again, it set forth the *per se* invalid rule, stating this rule should be applied only to lawyers who worked at firms and not to partners. The reasoning behind this decision was that partners were on an "equal footing" with one another, while employers and employees were not [4].

This distinction was short-lived, however, as in 1969 the committee released yet another informal opinion on the subject of covenants not to compete. The committee changed its principal rationale for the *per se* invalid rule, by stating that the main goal of this rule was to protect the rights of the clients rather than the rights of the lawyers. In doing so, the committee flatly rejected the application of the "equal footing" doctrine of Formal Opinion 521. The

committee rationalized that the distinction between partner and employer/employee was irrelevant because the covenant not to compete was just as harmful to the client in either situation [7]. The committee pronounced that covenants not to compete would “by their very expression tend to derogate from the trust and confidence necessarily inherent in relations between lawyers and their clients” [5]. It further stated that these agreements “treat the practice of law as a commercial business rather than a profession” [5]. Thus, although the reasoning behind the ban may have changed slightly in the early years; the fact remained that the Ethics Committee had firmly rejected the use of restrictive covenants among lawyers.

### **MODEL CODE OF PROFESSIONAL RESPONSIBILITY—DR-2-108(A)**

All of the discussion involving covenants not to compete among lawyers during the 1960s culminated in 1969 when the American Bar Associations adopted the Model Code of Responsibility. Disciplinary Rule 2-108(A) addressed the issue of restrictive covenants, stating:

A lawyer shall not be a party to or participate in a partnership or employment agreement with another lawyer that restricts the right of a lawyer to practice law after the termination of a relationship created by the agreement, except as a condition to payment of retirement benefits [8].

Yet, it was still not clear whether the American Bar Association intended DR 2-108(A) to promote the per se invalid rule or a balancing approach. Finally, in 1971, Informal Opinion 1171 cleared up any doubt as to how DR 2-108(A) should be applied; covenants to compete were per se invalid [7]. It would be four years later before the courts would make a major decision concerning DR 2-108(A).

### **DWYER V. JUNG**

The first substantial case to rely on the Model Code’s DR 2-108(A) was decided in a New Jersey state court in 1975 [9]. In *Dwyer v. Jung*, the partnership agreement provided that upon a dissolution, clients would be assigned to a particular lawyer and all of the partners would be “restricted” from doing business with a client who was assigned to another partner. The court held the restrictive covenant in the partnership agreement was per se invalid against public policy, saying “the attorney-client relationship is consensual, highly fiduciary on the part of counsel, and he may do nothing which restricts the right of the client to repose confidence in any counsel of his choice” [9]. Thus, *Dwyer* laid the foundation for

other courts to enforce Disciplinary Rule 2-108(A) and also to expand on its holding.

### **GRAY V. MARTIN**

An example of the expansion of the *Dwyer* holding arose in the Oregon Court of Appeals in 1983 [10]. In *Gray v. Martin*, the court held a forfeiture provision in the partnership agreement was prohibited under Disciplinary Rule 2-108(A). The agreement provided that if a partner withdrew, s/he would be entitled to his/her unpaid draw, partnership interest, and capital account. But if the attorney withdrew and then started a new practice within any of the several surrounding counties listed in the agreement, the attorney would forfeit a portion of the partnership interest [10].

The firm put forth two arguments to support that its agreement did not violate DR 2-108(A). The first argument was that the agreement fell under the retirement exception to DR 2-108(A). Under this exception, even an unreasonable restrictive covenant will be enforced if the employee signed the agreement in exchange for some type of retirement benefits [10]. In rejecting this argument, the court stated that the firm's interpretation of DR 2-108(A) was too broad because any time a partner left the firm could be considered a retirement and thus DR 2-108(A) would have no power. The second argument of the firm was that the agreement provided only for an economic disincentive, and therefore it was not a restrictive covenant. But the court also rejected this argument, stating these "economic disincentives" were financial penalties that were just as much of a restriction as an outright ban. The court concluded that the effect of Disciplinary Rule 2-108(A) is to make the covenant clause unenforceable, since the objective of the rule is to "govern the relationships between attorneys for the protection of the public" [10]. The court admitted this provision did not technically restrict the location in which a departing lawyer could work. But since the agreement would make the attorney give up benefits that would otherwise be owed to him/her, the attorney may decide not to represent former clients because of the agreement, ultimately affecting the clients' choice of counsel.

Thus, the *Gray* decision expanded on the holding in *Dwyer* by applying DR 2-108(A) to forfeiture provisions that were combined with covenants not to compete. Courts in Oregon and across the country relied on *Gray* to strike down any attempts by law firms to restrict departing attorneys' work locations or clientele. Yet, as time progressed in the prosperity of the 1980s, movement among lawyers, especially among the firms' "top guns" to other firms increased. Chief Justice Rehnquist stated "partners in law firms have become increasingly mobile, feeling much freer than they did in the past and having much greater opportunity that they did in the past to shift from one firm to another and take revenue-producing clients with them" [11]. Thus, it was becoming more important than ever to the financial interests of the firms to come up with agreements

that would discourage attorneys from leaving the firm and taking their clients with them. But the courts continued their ban on restrictive covenants for attorneys.

### **COHEN V. LORD, DAY, & LORD**

One of the most widely followed cases of the 1980s pertaining to attorney restrictive covenants was the *Cohen* case [12]. Richard Cohen was the head of the tax department at Lord, Day, & Lord, for which he had worked twenty years. Cohen left the firm to join one of Lord's competitors, taking several clients with him. Under the partnership agreement, Cohen's former partners refused to pay him a share of the firm's profits that was due him, relying on the clause in the partnership agreement that prohibited certain payments to any withdrawing attorney who competes with his/her former firm [12]. Cohen sued, claiming the restrictive covenant was unenforceable. Ironically, Cohen had previously benefited from the restrictive covenant when it was applied to other partners who had withdrawn from the firm. Cohen even helped draft the restrictive covenant. Yet the trial court agreed with Cohen, holding the clause violated DR 2-108(A). The appellate division reversed, holding the reduction in compensation did not constitute a restriction on the attorney's ability to practice law [12].

The New York Court of Appeals reversed, concluding the clause in the partnership agreement was a forfeiture clause, citing *Gray* as support:

We hold that while the provision in question does not expressly prohibit a withdrawing partner from engaging in the practice of law, the penalty it enacts if he does withdraw . . . constitutes an impermissible restriction on the practice of law. The clause would functionally discourage a withdrawing partner from serving clients who might wish to continue to be represented by the withdrawing attorney and therefore interfere with the clients' choice of counsel [12].

The court did recognize that the firm's future financial interests were a legitimate protectable interest. However, the court did not compare the financial impact on the firm to the amount the firm would withhold from the withdrawing attorney. If it had done this, it would have been able to see whether the forfeited amount by the departing attorney was greater than was reasonably necessary to protect the firm's legitimate financial interests [13]. Rather, the court of appeals distinguished the forfeiture money already earned by the withdrawing attorney from the future income to the former firm. But this distinction was irrelevant and unnecessary because the court justified its decision based on protecting client choice, not on protecting the attorney's financial well-being [13].

The *Cohen* case reasoning was followed by many courts across the United States. Courts were almost unanimous in their holdings that covenants not to compete among attorneys were against public policy. It did not matter whether the agreement called for an outright ban on competition or only required a

financial forfeiture. Regardless, law firms continued to include restrictive covenants in their partnership agreements, hoping to at least intimidate withdrawing partners or that a court would one day rule in their favor [7]. The *Haight, Brown, & Bonesteel* case was the first court to uphold the covenant.

### ***HAIGHT, BROWN, & BONESTEEL V. SUPERIOR COURT***

In the *Haight* case, seven partners left the firm to start their own competing firm across the street. The new firm's partners transferred more than 900 cases from their old firm to their new firm [14]. The partnership agreement stated that any withdrawing partner:

who engaged in any area of the practice of law regularly practiced by the law firm and in so doing represented any client of the firm for twelve months after leaving the firm would forfeit any and all rights and interests entitled to a departing partner . . . and the agreement was designed to comply with and take advantage of the provisions of the California Business and Professions Code Section 16602 [14].

The trial court held that the covenant not to compete in the partnership agreement was "invalid and unenforceable as a matter of law" [14]. In a startling decision, the court of appeals reversed. The court held the partnership agreement did not "expressly or completely prohibit the former partners from practicing law or from representing any client" [14].

The court also soundly rejected the lower court's interpretation of professional Rule 1-500 as a per se ban on covenants discouraging competition [13]. Rule 1-500 prohibits lawyers from entering into any agreement in which the lawyer agrees to abstain from practicing law altogether. The court of appeals used a broad reading of Rule 1-500 to allow a "balancing between competing interests," stating that Rule 1-500 required "respect for the integrity of the relations among the lawyers" as well as taking into consideration respect for the client [13]. The court said both of the competing interests must be addressed. On one side is the interest of the withdrawing partners and their ability to practice law anywhere and also be able to take any of their former firm's clients. On the other side is the interest of the former firm to preserve the financial security of the firm by using the withdrawing partner's share of accounts receivable and capital accounts to offset the income lost when the withdrawing partners took their clients with them to the new firm [13].

The court of appeals also relied on a previous case involving a similar forfeiture clause and covenant not to compete in a partnership agreement for doctors [15]. (The court upheld the doctors' partnership agreement, which stated that if a withdrawing partner competed with the former partnership, the withdrawing doctor waived his/her share of the accounts receivable.) Noting that a confidential

relationship did exist between an attorney and his/her client, the court nonetheless proclaimed this relationship was no more special than other professional relationships. Therefore, the court refused to impose a stricter rule on attorneys than on other professionals and thus held attorneys were permitted to enter into covenants not to compete under Section 16602 [1].

The *Haight, Brown, & Bonesteel* case signified a major departure from prior case law for several reasons. One major difference was the refusal by the California court to equate the forfeiture provision in the partnership agreement as a prohibited restriction on the attorney's right to practice law and a client's right to the lawyer of his/her choice, rejecting the holding in *Cohen* [1].

Another major difference was the California court's refusal to place lawyers in a higher class of responsibility with respect to covenants not to compete as compared to other professionals, such as physicians and accountants [1]. Thus, the thirty-year rule of the per se ban on covenants not to compete among lawyers was now in doubt. Would *Haight* signify a major change in the legal profession or was this case just an aberration?

### **HOWARD V. BABCOCK**

The dust had barely settled on the *Haight* case when another California case came into the spotlight. In *Howard v. Babcock* [16], the Babcock firm had in its partnership agreement that lawyers who withdrew from the firm were prohibited from practicing insurance defense with any of the other partners or associated for one year in the surrounding counties. If they did, the former firm would withhold all withdrawal benefits [16].

In 1987, four former partners of the Babcock firm started their own firm, representing clients from the Babcock firm in approximately 200 cases of insurance defense. The former firm, citing the partnership agreement, refused to pay the defecting lawyers any money for the works in progress or for the accounts receivable [16]. The withdrawing partners brought suit, alleging the restrictive covenant was unenforceable. The fourth appellate district court refused to apply Section 16602 of the California Business and Professional Code to lawyers, thus rejecting *Haight* and holding for the withdrawing partners.

The supreme court of California reversed, remanding for the court of appeals to determine whether the agreement "constituted liquidated damages" or "impermissible penalties" [16]. The court held that in the state of California, covenants not to compete in partnership agreements among lawyers are subject to the reasonable test that is subject to ordinary covenants not to compete and that they are no longer per se invalid [16].

The supreme court acknowledged it was breaking with national precedent in its decision. Yet, it said this break was necessary due to "a revolution in the practice of law that had occurred, causing law firms to protect their economic interests just as other business enterprises do" [16]. The court cited several factors that led it to

believe a “revolution” had occurred. The court noted the increasing frequency of firms, even large, supposedly stable firms, splitting up and partners taking as many clients with them as they could [16]. Also, the court stated the increase in lateral hiring, even among top-level partners, showed that firms were no longer the stable institutions they once were thought to be [16]. Thus, the supreme court decided, due to these “sweeping changes in the legal profession,” the per se ban on covenants not to compete was no longer valid [16]. The California supreme court’s holding followed the reasoning of *Haight* as it delivered a devastating blow in California to the per se invalid rule of covenants not to compete among attorney-partnership agreements.

### WHO IS RIGHT?

The large majority of jurisdictions still holds that covenants not to compete in lawyer-partnership agreements are per se invalid. But since the *Babcock* decision in California, some courts want to apply the same standard to these agreements as would be applied to an agreement in any other profession, i.e., the reasonableness standard. Still other commentators believe both of these applications are wrong and a middle ground approach should be applied.

### PER SE INVALID RULE

The Model Code of Professional Responsibility has been the leader of the per se invalid rule. The main goal of the rule is to protect the interests of the client and to protect the autonomy of the lawyer. The courts in *Dwyer*, *Gray*, and *Cohen* all relied on the model code in their decisions. For example, an attorney decides to leave a firm. S/he opens up a competing law firm and some of his/her former clients would like him/her to continue as their attorney. If the agreement were enforceable, the withdrawing attorney may refuse to represent clients from the former firm because of the financial penalty that would be imposed. Thus, the clients’ would suffer because they would not be represented by the counsel of their choice.

The second reason given by ethical committees for banning covenants not to compete is to protect the autonomy of the lawyer. If the covenant were enforceable, a lawyer’s ability to move from firm to firm would be curtailed due to the financial penalty that would be imposed. The ethical rules state an attorney has the right to practice where s/he chooses. Therefore, restrictive agreements cannot be enforced [17].

### REASONABLE TEST

Generally, a covenant not to compete will be reasonable if the agreement is reasonably necessary to protect the employer’s legitimate business interests and



the restrictions themselves are not viewed as unreasonable as to time and geographic area. The *Haight* and *Babcock* courts applied the reasonable test standard to attorney covenants not to compete as they chose to abandon the per se invalid rule. These courts held that a determination must be made by some economical analysis to determine whether the financial loss to the withdrawing partner so greatly exceeded the gain of their future income as to constitute a penalty that went beyond protecting the legitimate financial interest of the firm [14, 16].

By applying the reasonable test to attorney covenants not to compete agreements, the court can take into account the unique importance of protecting the client's choice, while still offering some protection to the withdrawing attorneys and their former firms [18]. Proponents of the reasonable rule cite several factors for using this rule as opposed to the per se ban on attorney covenants not to compete:

1. Whereas the per se ban allows the withdrawing party to break its agreement and disregards the financial impact on the former firm, the reasonable test protects the client while still enforcing the parties' expectations. The reasonable test will thwart attempts by attorneys who sign agreements with their partners, breach the agreement, and then try to hide behind the ethical codes as a shield from liability [4, 18].

2. The reasonable test allows the courts to recognize differences in client sophistication. The ethical rules want to protect the unsophisticated client from the sophisticated attorney who trades away the client's choice without the client ever realizing what is happening [4]. In complex cases with well-informed corporate clients, the court does not have to apply as stringent a rule and therefore can take into consideration the legitimate concerns of the law firm without harming the client. On the other hand, in a case where a longstanding individual client relies blindly on his attorney, the court can require a more narrowly construed agreement to protect the client's choice [4, 18]. Thus, the reasonable test will allow the court to interpret the agreement in accordance with respect to the capabilities and understanding of the client.

### MIDDLE GROUND APPROACH

Still other commentators believe both the per se ban and the reasonable test are inapplicable. They agree with the *Haight* and *Babcock* opinions that the increase in attorney mobility among firms has necessitated the protection of the law firm and that the per se rule prohibiting covenants not to compete are too inflexible. Yet, they believe a higher standard is required for attorneys than the reasonable test that is applied to regular business situations [4].

Under the middle ground approach, for an attorney restrictive covenant to be enforceable, "the amount of damages must not be so excessive that an economically rational lawyer would decline representation of the firm's clients. If a

reasonable attorney would be forced to decline representing these clients then the agreement would restrict the practice of the law and would thus be unenforceable" [4].

Critics of this approach state it would be difficult for an attorney to determine the amount of revenues s/he can expect to earn from a client in the future. Thus, it would be almost impossible for a departing lawyer to weigh the costs of violating the restrictive covenant to the future expected earnings from representing the former firm's clients. Although supporters of the middle ground approach agree with the above statement, they believe the message this approach sends to law firms is that damage provisions in covenants cannot be excessive and even though this approach is not exact, it is the price law firms must pay to maintain high legal ethics [18].

## CONCLUSION

The future of covenants not to compete among lawyers still has a solid foundation in the per se invalid rule, although some cracks have developed. It appears law firms will continue to place these covenants in their partnership agreements even though most courts today will not enforce them. The deep-rooted commitment of legal ethics committees to protect the clients' interests as well as protecting lawyers who are not on an equal bargaining position with partners will overshadow the firm's survival.

But the recent California decisions have shown that the per se rule is not absolute. Their break with national precedent will no doubt continue to raise the hopes of law firms who wish to enforce these restrictive covenants, relying on the fact that the survival of the firm must be taken into consideration as the practice of law becomes more and more like a business.

The issue of covenants not to compete in law firm partnership agreements will continue to be a hot issue. Major changes appear unlikely in the near future, but as the legal profession continues to become more and more competitive, courts will have no choice but to take another look at the per se rule.

## ENDNOTES

1. Kafker, "Golden Handcuffs: Enforceability of Non-Competition Clauses in Professional Partnership Agreements of Accountants, Physicians and Attorneys," 31 *American Business L.J.* (1993).
2. Weems, "Covenants Not to Compete: Recent Missouri Decisions," 50 *J. Mo. B.* 169, (May/June 1994).
3. ABA Committee on Professional Ethics, Formal Op. 300, (1961).
4. ABA Committee on Ethics and Professional Responsibility, Informal Op. 521, (1962).
5. ABA Committee on Professional Ethics, Formal Op. 1072, (1969).
6. Canons of Professional Ethics, Canon 7, (1908).

7. Caiccio, "*Howard v. Babcock*, The Business of Law v. The Ethics of Lawyers: Are Non-Competition Covenants among Law Partners against Public Policy?" 28 Ga. L. Rev. 807 (Spring 1994).
8. Model Code of Professional Responsibility DR 2-108(A) (1969).
9. *Dwyer v. Jung*, 336 A.2d 498, aff'd 348 A.2d 208 (N.J. Super. Ct. 1975).
10. *Gray v. Martin*, 663 P.2d 1285 (Or. Ct. App. 1983).
11. The Legal Profession Today, 62 Ind. L.J. (1987).
12. *Cohen v. Lord, Day, & Lord*, 550 N.E. 2d 410 (N.Y. 1989).
13. Penasack, "Abandoning the Per Se Rule against Law Firm Agreements Anticipating Competition: Comment on *Haight, Brown, Bonesteel v. Superior Court of Los Angeles County*," 5 Geotwn L. J. 889 (1992).
14. *Haight, Brown, Bonesteel v. Superior Court of Los Angeles County*, 234 Cal. App. 3d 967.
15. *Farthing v. San Mateo Clinic*, 299 P.2d 977.
16. *Howard v. Babcock*, 863 P.2d 150 (Cal. 1993).
17. Draper, "Enforcing Lawyers' Covenants Not to Compete," 69 Wash. L. Rev. 161 (Jan 1994).
18. Committee on Professional Responsibility, Association of the Bar of the City of New York, "Ethical Issues Arising when a Lawyer Leaves a Firm: Restrictions on Practice," 20 Fordh. Urban L.J. 897 (1993).

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