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An Economic Analysis of Conflict of Interest Regulation

Jonathan R. Macey* and Geoffrey P. Miller**

ABSTRACT:
This paper analyzes the ethical rules applicable to attorney conflicts of interest as default terms which the legal system supplies in the absence of complete contracting by the attorney and client. Following an approach that is standard in the literature, we model the attorney-client relationship as an agency contract characterized by information and monitoring difficulties. We conclude that, in general, a regime that grants the client the right to bar subsequent, conflicting representation of other parties by the attorney, subject to ex post renegotiation by the attorney and client, represents an optimal approach to the problem. Economic theory predicts, however, that there is a threshold of harm to the client, below which the attorney should be allowed to represent another party without obtaining the first client's consent. In general, the ABA Model Code of Professional Responsibility and Model Rules of Professional Conduct adopt a regime of conflicts regulation that is quite consistent with economic theory. We suggest that the bar has an incentive to adopt efficient rules in this area because its interests are closely aligned with the public's: both have an interest in facilitating efficient contracting between attorney and client—the bar, to increase profits; the public, to reduce costs.

AN ECONOMIC ANALYSIS OF CONFLICT OF INTEREST REGULATION

The concept of legal "ethics" is deeply embedded in the notion of law as a learned profession. Lawyers are expected to behave in accordance with a high standard of morality. Ethical issues are grist for the mills of popular television series and best-selling mysteries.

The concept of "ethics" carries a powerful normative connotation; it suggests that legal ethics has a large moral component and might in fact be seen as an applied branch of moral philosophy. Consistent with this normative thrust, the system of legal ethics is often understood as a moral code for the legal profession.¹ Yet there is an undeniably powerful eco-

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nomic element in legal ethics rules as well. These rules control the basic elements of the business of lawyering, from entry into the profession (licensure), to the types of market development which the attorney can undertake (advertising or solicitation), to the terms of the contracts with customers that the lawyer can negotiate (retainers). As ethics scholar Stephen Gillers observed, law is a regulated industry. Among the principal regulations that control the activities of this industry are the rules of legal ethics. Thus, while ethical rules undoubtedly have a moral component, they also have an economic function.

A superficial application of economic principles might suggest that ethics rules are likely to be uniformly inefficient. For the most part, these rules are promulgated by the organized bar without substantial input from other interests. In particular, clients (other than large organizations with in-house attorneys) are not strongly represented in the councils which formulate bar rules. One might argue, therefore, that ethics rules represent a naked exercise of guild power, serving the interests of lawyers at the expense of clients or the general public. But this would be an oversimplification. The organized bar, which has principal responsibility for drafting the rules of legal ethics, can enhance its profits in at least two ways: first, by limiting the supply of legal services available in the marketplace (mainly by restricting entry into the practice of law); and second, by adopting economically efficient rules that reduce costs (in part, by lowering the contracting costs between lawyers and clients). Either a reduction in costs or a decrease in supply will increase the profitability of legal services, and by engaging in both techniques simultaneously, the bar can enhance profits still more and do so over the long run.

The efficiency implications of the supply-restricting and cost-reducing strategies utilized by the organized bar are complex and require careful case-by-case analysis. As a broad generalization, however, it would appear that while supply-reducing rules are likely to be inefficient on balance (because the welfare loss associated with the reduction in supply is greater than the welfare benefit that might be achieved by providing quality assurance), cost-reducing rules are likely, in many cases, to be efficient (because the bar's interest in reducing the cost of providing legal services


4. Note, however, that the increased profits the bar can obtain through lowering contracting costs will eventually dissipate as a result of competition unless they are coupled with supply restrictions.
CONFLICT OF INTEREST REGULATION

aligns well with the public's interest in efficient contracting). Thus, while some ethics rules can indeed be understood as serving the interest of the organized bar at the expense of social wealth, other rules, arguably, can be justified on economic grounds. Efficient ethics rules are those that reduce contracting costs between lawyers and their clients by supplying reasonable terms to which lawyer and client would agree, in most cases, if they were to bargain over the issue.

The codes of professional responsibility, in other words, contain a number of "gap-filling" or "default" rules that supply terms to an attorney-client contract. Among the most important of such rules are those related to conflicts of interest.

In part, our purpose is to identify an efficiency rationale for certain rules that have heretofore generally been analyzed from other, principally moral and ethical, perspectives. We believe that economic analysis can provide a satisfactory and coherent explanation for the structure of rules that we observe in the legal ethics area. Through the economic lens the rules in question can be seen as supplying reasonable implied terms to the attorney-client contract in an environment characterized by information asymmetries, agency costs, dangers of ex post opportunism, and associated costs of monitoring and enforcement.5

A second purpose of this paper is to suggest an economic framework for interpreting the gap-filling rules in cases of ambiguity. Once the economic function of these gap-filling rules is clarified, they can be interpreted in a fashion that is likely to enhance the efficiency of the provision of legal services. Efficiency-based interpretations turn out to be generally consistent with reasonable moral intuitions, but they are, in some cases, at variance with the constructions that courts or commentators have adopted. Thus, economic analysis of the gap-filling rules of attorney ethics may provide guidance for the interpretation of the rules of legal ethics in hard cases.

This paper is structured as follows. Part I presents the lawyer-client relationship as an agency relationship with problems similar, in many respects, to those arising in many other settings, but with a number of features that are not present, or not present in equal degree, in other agency relationships. Part I then discusses the theory of gap-filling in the law-and-economics literature, and considers the problems of agency and gap-filling in the special context of the attorney-client relationship. Part II analyzes the conflicts of interest rules from the perspective of legal-economic theory and offers theoretical reasons why the rules might be generally consonant with economic efficiency, notwithstanding the fact that they have been adopted by the bar to regulate its own behavior. The paper closes with a brief conclusion.

5. For another commentator who found that the conflicts of interest rules seem to work quite well when viewed from the lens of economic analysis, see Richard A. Epstein, The Legal Regulation of Lawyers' Conflicts of Interest, 60 Fordham L. Rev. 579, 582 (1992).
THE ECONOMIC ANALYSIS OF LEGAL REPRESENTATION

A. Legal Representation as an Agency Relationship

Lawyers function as agents for their clients. Often this is true in a technical sense; for example, when the attorney is conducting negotiations, executing documents, or otherwise acting on the client's behalf in a legal matter, he or she functions as the client's legal agent. The very concept of "representation" implies agency: the attorney champions the client before a tribunal or in some less formal setting and, thus, acts on behalf of the client's interests.

All agency relationships carry the possibility that the agent will be unfaithful. The legal profession is no exception. The possibility that attorneys will serve their own interests at the expense of their clients' is widely recognized by society at large, as evidenced by the plethora of lawyer jokes that have been popular since at least the Middle Ages. Lawyers may overbill or pad their fees, settle litigation on terms less favorable than they could have obtained with greater effort, conduct class action and derivative litigation as "entrepreneurs" interested in maximizing their own income, and even shade their legal advice out of motives of self-interest. These aspects of the attorney as a self-interested agent may occasionally encounter criticism in the scholarly literature, but even critics of the pure agency model generally concede that the attorney-client

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6. As one of us has argued, this point was well known (and regulated by legal norms) even in preliterate societies. See Geoffrey P. Miller, Contracts of Genesis, 22 J. Legal Stud. 15, 34 (1993) (arguing that many biblical narratives should be understood, in part, as legal texts).


10. See Donald Langevoort & Robert K. Rasmussen, Skewing the Results: The Role of Lawyers in Transmitting Legal Rules, 5 S. Cal. Interdisc. L.J. 375 (1997) (noting that attorneys may overstate legal risks to clients in order to protect their own interests).

relationship has substantial elements of agency; their objections tend to go to the exclusivity of the agency model rather than its overall descriptive accuracy.

The attorney-client relationship is also an agency relationship in economic theory.\(^2\) Every time one person (the agent) acts on behalf of another person (the principal), the agent has an incentive to shirk or serve his own interests, simply because the agent does not capture the full benefit of his labor. In legal representation, as in other areas, the only way to truly eliminate the agency problem is to eliminate the agency: if the client elects to represent himself in a legal matter, the client will capture all the benefits of the representation. But eliminating the agency problem by self-representation often creates greater costs than it saves, because the client is unlikely to be as skilled or knowledgeable at law as the attorney. Furthermore, even if the client possesses the requisite skills, the client may suffer from distorted judgment because his or her own self-interest is involved. No matter how loyal a person engaged in self-representation may be to his or her own interests, he or she will not be better off if the process generates a fool for a client.

Rather than eliminating the agency arrangement, private actors attempt to minimize these inevitable costs of agency by reducing the agent's incentives to act in ways that conflict with the principal's interests. Incentives can be changed in three principal ways, with varied effectiveness and associated costs. The most direct method to change the agent's incentives is for the principal to monitor the agent's behavior and to intervene with an appropriate sanction in the event of shirking or other disloyal behavior. With perfect monitoring, the sanction for misbehavior is set at a level that removes the incentive that the agent would otherwise have to shirk. Moreover, because the agent understands that he is being perfectly monitored and will suffer the sanction if he shirks, it will rarely, if


For an interesting paper modeling some forms of representation as means by which the attorney as agent can enhance cooperation between disputing parties, see Ronald J. Gilson & Robert H. Mnookin, Disputing Through Agents: Cooperation and Conflict Between Lawyers in Litigation, 94 Colum. L. Rev. 509 (1994). For papers applying economic agency theory to the attorney-client relationship, see, for example, Coffee, supra note 9; Epstein, supra note 5; Langevoort & Rasmussen, supra note 10; Macey & Miller, supra note 9.
ever, be necessary for the principal to actually administer the sanction. The mere presence of the sanction will be enough to deter the agent from shirking in the first place. In the real world, of course, monitoring is never perfect and incentives can never be set at the precise level necessary to deter shirking; as a result, agents do shirk and intervention is required from time to time.

The second method of controlling agency costs is for the principal to alter the agent's incentives without ongoing monitoring. The principal selects an objective measure of output and rewards (or punishes) the agent depending on performance. Under very restrictive conditions—the principal perfectly defines the desired objective, the agent completely controls whether or not the defined result is obtained, and the structure of rewards and punishments is set so that the agent never has an incentive to shirk, even though the agent is not being watched—the parties could, in theory, perfectly control agency costs without any monitoring of the agent's actual behavior. Again, however, in the real world it is impossible to establish a perfect structure of incentives based on output: there will inevitably be overdeterrence or underdeterrence; it will be difficult, in most cases, to define the desired performance objective with precision; and the agent will have incentives to shirk when the agent believes he can get away with it.

The final method for controlling agency costs uses the sanctioning apparatus of the state. State intervention can reduce the agent's incentives to shirk by threatening the agent with penalties for doing so and by establishing norms that discourage shirking even if the parties have not explicitly specified terms in their contracts that anticipate the agency problem. State intervention can reduce transaction costs by relieving the parties of the need to negotiate their individual contracts; it also might have a valuable in terrorem effect by threatening the agent with an extreme sanction for noncompliance. However, state intervention is subject to drawbacks equally or even more serious than the private mechanisms discussed above: the state may overdeter or underdeter by threatening a sanction that is too harsh or too lenient under the circumstances; it may fail to detect violations or may punish behavior which is, in fact, appropriate; and it may impose inefficient conditions on the parties which they might not have agreed to through private bargaining.

All forms of altering the agent's incentives to overcome the agency problem are, therefore, problematic and costly. The problem for economic theory is to devise an approach that minimizes the sum of all the costs—including the residual costs of shirking by the agent.

Although the attorney-client relationship has the same structure as other agency relationships, it differs from some other agency relationships in the degree to which it is resistant to many of the incentive-altering techniques that reduce (but never eliminate) the agency problem in other settings. The main source of this resistance in the attorney-client relationship is the severe informational asymmetry between the parties. The lawyer possesses a store of specialized knowledge, skill, and judgment
that the client lacks.\textsuperscript{13} Because clients often cannot distinguish good legal work from bad, the client will rarely be an effective monitor of the attorney's behavior (unless the client is a sophisticated party, such as a firm that employs its own in-house counsel). The client will have only a vague idea of how many hours the attorney should spend on a project under an hourly fee arrangement, whether the attorney has conducted the legal research well or poorly, and whether the attorney is making good arguments or bad ones. Furthermore, when the client has only a small stake in the controversy, as in some class action or shareholders' derivative litigation, any potential monitoring role the client may have becomes vestigial at best.\textsuperscript{14}

Agency costs in the attorney-client relationship are also, in most settings, resistant to the use of direct incentives based on performance. Except in cases where results can be obtained reliably and with certainty—for example, a simple incorporation or a name change—it will ordinarily be impossible to specify an objective performance measure that the attorney must achieve in order to obtain a given reward or to avoid a given sanction. Even good attorneys lose cases, and bad ones win them.\textsuperscript{15} Moreover, any measure of attorney compensation based on outcomes creates a form of reverse agency problem, in that the attorney's ability to predict whether he or she will achieve a given result depends crucially on the accuracy of the information that the client provides. Just as informational problems hamstring the client in judging the attorney's skills and competence, the attorney's inability to get complete and reliable information from the client about the nature and background of the representation may impede his or her ability to provide effective representation. Incentive problems can be mitigated through contingent fee arrangements, which are a partial sale of the claim to the attorney, but such problems inevitably may remain as long as the attorney has no more than a partial interest in the litigation.

These difficulties with private mechanisms for controlling agency costs suggest the possible utility of government regulation. The government may be able to act as a more accurate monitor or to impose more effective penalties than would be available under a regime of private contract. The government, moreover, may be able to respond to the externalities (if any)
that are created as a consequence of the attorney-client relationship. However, government intervention in the attorney-client context is also problematic for a number of reasons. Because of the inevitably fact-specific and individualized nature of most legal representation, the government, as a disinterested third party, is unlikely to be an effective monitor of the parties' conduct. To the extent that the government actually influences the terms of the attorney-client relationship by direct regulation (for example, by prohibiting or limiting certain contingent arrangements), rather than merely enforcing the parties' private agreement, the government may impose conditions that may not reflect the parties' best interests. Government agencies are often subject to budget constraints that may hamper their ability to function as effective regulators. And, government intervention in the attorney-client relationship is especially problematic because the assistance of counsel is a right which the citizen enjoys in order, in part, to obtain protection against government abuse. Thus, government control over the attorney-client relationship is fraught with as many (or possibly more) difficulties as private control through contract.

B. The Contractual Approach To Agency Costs

The difficulty inherent in government control over the attorney-client relationship suggests that, in the absence of significant externalities, the government's principal role should be limited to enforcing the parties' contract. The attorney and client are better situated to control agency costs by private agreement. However, in many cases, the parties' agreement will be ambiguous as applied to a particular fact pattern, or the parties may have failed to address an issue altogether. In such cases, efficiency considerations suggest that the government's role should ordinarily be to supply reasonable "gap-filling" or default terms that the parties likely would have agreed to if they had bargained over the issue ex ante.  

The efficiency benefits of contractual default rules are numerous. When the marginal costs of drafting customized rules to govern the attorney-client relationship exceed the marginal benefits, there is an efficiency gain when the state can supply standardized terms to which, in  

general, both parties to a contract could agree ex ante. Another benefit of contractual default rules is that they can reduce search costs that parties would otherwise incur in determining the contractual terms offered by different service providers. By standardizing the terms, the law facilitates comparison shopping along a few dimensions of quality. This standardization can be especially important in inefficient markets, where quality dimensions of a product or service may not be captured in a public, observable market price.

Whereas the superior efficiency of individually drafted and standardized gap-filling terms is usually clear, mandatory rules can be justified on efficiency grounds in a few settings. Most importantly, where third party effects are present, it may be appropriate to trump the agreement of the parties in order to control externalities. The law may also choose not to enforce the apparent agreement of the parties if there is evidence that it does not reflect a true meeting of the minds, as in the case of mistake or incapacity. In the case of a contract between an attorney and an unsophisticated party, a court might conclude that terms drafted by the attorney that are adverse to the client do not represent the true agreement of the parties, and the court might then supply reasonable default terms to fill the resulting gap.

C. Complete and Incomplete Contracts in the Attorney-Client Relationship

In this section, we consider the implications of agency problems in legal representation as they relate to conflicts of interest. We present the conflicts of interest rules as gap-fillers applicable when the attorney-client contract lacks express agreements on the question in point.

18. In securities markets, for example, the market price does reflect a discount for differences in governance structures, thus making standardized governance terms less desirable for publicly traded firms than, say, for small or nonpublic firms. See Larry E. Ribstein, Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs, 73 Wash. U. L.Q. 369, 375 (1995).
19. See id. at 378.
20. We exclude from the analysis here, and throughout the paper, the possibility that the attorney-client relationship will have external effects on third parties that cannot be controlled entirely by means of a contract between attorney and client, even if the contract is perfect and complete. This exclusion is intended to simplify the analysis, which, even excluding externalities, turns out to be surprisingly complex. A more complete theory of the conflicts of interest would have to deal with what are undoubtedly significant third party effects in the attorney-client relationship. For literature that does consider external effects in certain aspects of the attorney-client relationship, see, for example, Stephen McG. Bundy & Einer Elhauge, Knowledge About Legal Sanctions, 92 Mich. L. Rev. 261 (1993) (discussing when and if legal sanctions are socially desirable and how sanctions affect legal advice); Louis Kaplow & Steven Shavell, Legal Advice About Acts Already Committed, 10 Int'l Rev. L. & Econ. 149 (1990) (arguing that legal advice can be irrelevant, socially desirable, or socially undesirable); Louis Kaplow & Steven Shavell, Legal Advice About Information to Present in Litigation: Its Effects and Social Desirability, 102 Harv. L. Rev. 565 (1989) (discussing generally whether to seek legal advice); Louis Kaplow & Steven Shavell, Private Versus Socially Optimal Provision of Legal Advice, 8 J.L. &
For starters, it is easy to see why an attorney's conflict of interest represents a form of agency problem. Two main agency problems can arise as a result of an attorney representing clients with conflicting interests either consecutively or concurrently. First, in consecutive representations, the attorney (A) may learn confidential information about a client (C1) during the course of the representation that he can then use to C1's disadvantage when representing another party with competing interests (C2, C3, etc.). Ordinarily, clients do not want their secrets revealed, and, if A discloses C1's secrets to C2 in order to enhance A's own stature or increase his fees in the second representation, C1 obviously has legitimate concern. Second, in concurrent conflict situations, the attorney who takes on C2 may reduce the vigor of representation of his current client C1. Because the attorney favors his own interest over those of C1, a form of agency cost results.\(^2\) C1 will inevitably object to A representing C2, even if C2 has interests that conflict with C1's. But if A gains more from the C2 representation than C1 loses, a positive joint product results from the undertaking, and the parties (A and C1) may be able to share the gains from that product, thus making themselves both better off.

To illustrate these points, we first consider the problem of conflict of interest in a perfect contracting environment and then move to an environment of imperfect contracting which more closely approximates the world in which attorneys and clients actually function. We then consider the efficiency consequences of a number of possible default rules within the imperfect contracting setting.

1. Perfect Contracting Environment

Consider the following hypothetical scenario. A and C1 are negotiating for a retainer agreement at time \(t\). A has no conflicting representation at this time. At some point in the future, \(t_f\), however, there is an even chance that A will have the opportunity to undertake a conflicting representation for either C2 or C3, thus imposing costs on C1 which would not be imposed if the first representation had never occurred. Twenty-five percent of the time A has the opportunity to represent C2, earning a profit of $10 and imposing a cost of $15 on C1; 25\% of the time A has the opportunity to represent C3, earning a profit of $8 and imposing a cost of $2 on C1 (assume for convenience that all amounts are discounted to present value and that A earns all the surplus generated by the representation of C2 or C3). These potential losses to C1 are due to

\[^2\] Clients may also have an interest in maintaining the integrity of the work-product which their attorneys generate. For example, clients may legitimately expect that an attorney who drafts a contractual term for them will not turn around and seek to nullify the force of the same term during representation of a subsequent party.
the following factors: A's prior familiarity with CI's case, which may make him a more informed or effective advocate than other attorneys; A's willingness to use attorney-client confidences obtained in the initial representation to the detriment of CI; or, if the representation of CI is ongoing, the reduced vigor of A's representation of CI that results from the existence of divided loyalties. Faced with these possibilities, A and CI have the option of either barring all conflicting representation or permitting all.

It might seem from this scenario that A should be absolutely precluded from the subsequent representations of C2 and C3. After all, the existence of the first representation might be used to the detriment of CI. Why should attorneys, unlike other agents, be allowed to behave in a disloyal way that imposes real costs on their clients—costs, moreover, that presumably benefit a party with whom CI has an adversarial relationship? It does not require much thought to realize that this intuition is false. As the following table illustrates, the parties are jointly better off if A is allowed to undertake the conflicting representation:

<table>
<thead>
<tr>
<th>No Conflict</th>
<th>C2</th>
<th>C3</th>
<th>Net</th>
</tr>
</thead>
<tbody>
<tr>
<td>CI</td>
<td>$0.00</td>
<td>($3.75)</td>
<td>($0.50)</td>
</tr>
<tr>
<td>A</td>
<td>$0.00</td>
<td>$2.50</td>
<td>$2.00</td>
</tr>
<tr>
<td>Joint</td>
<td>$0.00</td>
<td>($1.25)</td>
<td>$1.50</td>
</tr>
</tbody>
</table>

Thus, A and CI make themselves jointly better off ex ante by agreeing to allow the subsequent representations—by a total of $.25 on an expected value basis. If it were possible to specify a complete contract with respect to the possible future states of the world, A would be able to compensate CI by paying some amount for the right to engage in a conflicting representation, an offer which would be in CI's interest to accept.

It might, nevertheless, seem that regardless of whether the parties benefit ex ante, the second representation should be precluded because at time t₁, C2 and C3 will have a choice of other counsel. Given the fact that C2 and C3 can always (or nearly always) find some other lawyer able to conduct the representation, why should society allow A to represent C2 and C3 at time t₁ when that is directly harmful to CI? The answer is that CI would agree to the subsequent representation ex ante because A would pay an amount sufficient to induce him to do so. But implicit in the example is also the assumption that A would earn enough from the subsequent representation. If A is going to make no more than other attorneys in the marketplace from the representation, and if the legal marketplace is efficient, A would not pay C2 for the right to engage in the subsequent representation because A could earn just as much from other legal work without having to pay the bonus.

The fact that A earns a value in the second representation does not, however, make the subsequent representation a bad deal for either party or for society as a whole. Attorneys do earn rents (or quasi-rents) for
specialized skills, contacts, and knowledge, based, in part, on the attorney’s past experience. Thus, it appears quite plausible that an attorney at time $t$, having previously worked for $C_1$ on a matter with a legal or factual profile similar to the pending matter, would be able to charge a higher fee than other attorneys.

But what if $A$’s ability to earn profits in the second matter is, in fact, the direct result of his willingness to pass on to $C_2$ or $C_3$ sensitive information obtained from $C_1$ on a confidential basis? The possibility that such conduct will occur does not make it irrational for $C_1$ to consent ex ante to the subsequent representation. Effectively, $C_1$ consents to the appropriation and adverse use of his proprietary information, because $C_1$ receives, in exchange, a greater value than that which she is relinquishing. $C_1$ essentially sells information to $A$. Social welfare would be served by permitting $A$ to use $C_1$’s confidences adversely to $C_1$ in this situation: because both $C_1$ and $A$ are better off, and because no one else is worse off, social wealth is increased.

The example so far assumes that the probabilities of $A$ working on a matter for $C_2$ or $C_3$ are fixed and unchanging. Let us relax this assumption in favor of the more realistic one that, unless the contract contains protections restraining $A$’s conduct, $C_1$’s agreement ex ante to $A$’s subsequent conflict of interest representation will affect the probability that such a representation will occur. In other words, if $A$ is permitted to do so, he is likely actively to seek the work that generates the highest profits; he will, therefore, seek to represent $C_2$ and $C_3$, rather than other clients, and, between these two, he will more aggressively seek out the work for $C_2$ which pays $10 than the work for $C_3$ which pays only $8. How does this change the analysis of the efficiency implications? As long as the parties can engage in complete, costless contracting, the analysis does not change substantially. In a perfect contracting environment, $C_1$ will know that consent will increase the likelihood that $A$ will in fact engage in a conflicting subsequent representation, and will demand compensation for the increased risk—compensation that $A$ will be willing to pay as long as a positive bargaining range exists.

Assume, for example, that if $C_1$ consents ex ante to the subsequent representation on the above facts, the probabilities change so that there exists only a 20% chance that $A$ will not engage in conflicting representation. Assume also that if $A$ does engage in conflicting representation, there is an 80% chance that $A$ will work for $C_2$, earning a profit of $10 and imposing a cost of $15 on $C_1$, and a 20% chance that $A$ will work for $C_3$, earning a profit of $8 and imposing a cost of $2 on $C_1$.

<table>
<thead>
<tr>
<th></th>
<th>No Conflict</th>
<th>$C_2$</th>
<th>$C_3$</th>
<th>Net</th>
</tr>
</thead>
<tbody>
<tr>
<td>$C_1$</td>
<td>$0.00</td>
<td>($9.60)</td>
<td>($0.32)</td>
<td>($9.92)</td>
</tr>
<tr>
<td>$A$</td>
<td>$0.00</td>
<td>$6.40</td>
<td>$1.28</td>
<td>$7.68</td>
</tr>
<tr>
<td>Joint</td>
<td>$0.00</td>
<td>($3.20)</td>
<td>$0.96</td>
<td>($2.24)</td>
</tr>
</tbody>
</table>
CONFLICT OF INTEREST REGULATION

In this case, the parties would contract for A not to engage in the subsequent representation, because the joint product of the subsequent representation is negative. However, hypotheticals could easily be devised in which, despite the increased likelihood that A will engage in subsequent, conflicting representation if allowed to do so, the joint product between A and C1 would remain positive. In these cases the parties would agree ex ante to allow the representation.

Note that where the parties' joint product is negative as a result of the enhanced likelihood that A will engage in a conflict of interest, the parties would still contract to permit some subsequent representation if they could specify in advance the representations in which A could engage. The C2 representation in the above example represents a negative joint product for A and C1, but the C3 representation has a positive product: A wins more than C1 loses. If, therefore, we relax the assumption that the parties cannot determine in advance which future representation the attorney is allowed to undertake, it becomes apparent that the parties will permit some future conflicts of interest, even while prohibiting others: A and C1 would agree to allow A to represent C3, but not C2. This has the added benefit of regulating attorney opportunism while permitting value-increasing conflict of interest representations in the future.

2. Imperfect Contracting Environment

In light of the previous discussion, it seems clear that conflicts of interest would not be problematic if contracting between attorney and client were complete and costless. In the real world, however, contracting is neither complete nor costless, and several practical difficulties might affect the nature of the terms of an attorney-client contract that deals with conflicts of interest in a world of second-best. First is the problem of complexity. It is often impossible to specify in advance how different future states of the world should be handled, or even to predict with any degree of certainty what those future states would be. This does not mean that specificity is impossible; in some cases, A and C1 can foresee a possible subsequent representation and, having foreseen it, can determine how it is to be handled. But in the vast majority of cases, future events are not foreseeable. As a result, the attorney-client contract will inevitably be incomplete. The best course of action is for the parties to specify in broad terms what they view as the most important factors; however, such terms are often so uncertain as to be subject to difficulties of future interpreta-

Complexity is particularly problematic in light of the danger of opportunism inherent in these types of contracts. In the right circumstances, either A or CI can act opportunistically—by seeking an unbargained-for-consideration ex post. For example, in the case of an attorney, A may seek out representations that are adverse to CI in cases where A and CI would not have agreed to allow the new representation ex ante. Clients, too, might behave opportunistically by attempting to prevent attorneys from representing new clients in situations where A and CI would have agreed to allow the representation ex ante. Because it is impossible to specify all future states of the world in which opportunistic behavior is an option, it will be difficult for A and CI to control all future opportunism by detailed contractual provisions.

A problem related to complexity is that of quantification. In actual representation settings, A and CI may not be able to quantify, with even a pretense of precision, either the amount of their respective gains and losses in the event of a future representation by A of a client with a conflicting interest or the probability of the attorney undertaking such a representation if allowed to do so. It may, accordingly, be exceedingly difficult to settle on an amount of compensation that would cover CI's expected losses from such representation. The parties may, therefore, end up more or less shooting in the dark, and, if they are risk averse, they will end up worse off ex ante. They may decide that they prefer the relatively certain world in which subsequent representation is prohibited to an uncertain world in which subsequent representation is permitted, even if there was a chance that they could both be better off in the second world than in the first.

Finally, contracts between A and CI regarding A's future behavior suffer from difficulties in monitoring and enforcement. CI does not watch A on a day-to-day basis, especially after the relationship ends. CI will thus often have very limited ability to determine whether or not A is keeping his promises regarding subsequent representation. Even in litigation, where A's subsequent behavior is likely to be most easily observable, A may have opportunities to provide advice behind the scenes, without publicly disclosing his involvement. CI might also seek to make enforcement difficult; particularly, CI might claim that her ex ante agreement to permit subsequent conflicting representation was obtained without full disclosure, and thus is unenforceable. Some courts are likely to view this argument favorably given the differences in sophistication on matters of law that ordinarily exist in the attorney-client relationship.


24. We are grateful to Ian Ayres for oral comments which suggest the possibility that ex ante agreements between A and CI waiving CI's rights on conflicts of interest might run into enforcement problems in the courts.
Accordingly, despite the fact that, in theory, there may be a substantial number of cases in which A and C1 would agree, ex ante, to allow A to represent conflicting interests, the difficulties in creating a complete contract make it unlikely that the parties will, in fact, be able to set forth an agreement with clear application to all, or even most, future states of the world. In general, parties do not bargain with their attorneys about the scope of future conflicts of interest. This is not always the case, however, especially when the client is sophisticated in legal matters.

II. PROPERTY RULES AND LIABILITY RULES ON CONFLICTS OF INTEREST

These difficulties in drafting a contract that deals effectively with the problem of conflicting representation ex ante suggest that the state might have a positive role to play in supplying default terms that govern those cases in which the parties have not clearly specified the full scope of their agreement. The following section considers a number of possible default terms. Following prior work by Kaplow and Shavell, we divide the possible approaches into property rules and liability rules. A property rule gives the holder of the right the legal power to prevent any other party from infringing on that right. A liability rule does not give the holder of the right the legal power to prevent another party from infringing, but instead gives the holder the right to obtain compensatory damages from

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25. Stephen Gillers pointed out in comments on this paper that sophisticated clients and sophisticated law firms do bargain for conflict rules that differ from the default rules in the Model Rules:

[F]or example, a law firm that is particularly skilled in a specialized area of law will demand that new clients seeking its services in that area agree to waiver of certain prospective conflicts. . . . A firm with specialized expertise will often be able to secure the waiver. Separately, substantial clients are able to negotiate for conflict rules more demanding of a law firm than the default rules provide.

Memorandum from Stephen Gillers, Professor of Law, New York University, to Jonathan R. Macey, J. DuPratt Professor of Law, Cornell University, and Geoffrey P. Miller, Professor of Law, New York University (Aug. 8, 1996) (on file with authors) [hereinafter Memorandum from Stephen Gillers].

the infringing party. In operational terms, courts typically enforce property rights through injunctive relief, whereas liability rules are typically enforced through monetary damages.

Given the property rule/liability rule distinction, there are four possibilities in the A-C1 relationship: (i) A has the right under a liability regime; (ii) C1 has the right under a liability regime; (iii) C1 has the property right; and (iv) A has the property right. The first of these possibilities, however, is not relevant because the only question is A's right to engage in the C2 representation, and under a liability regime there are no situations in which C1 would owe money damages. Accordingly, we can exclude the first case and consider the other three possibilities.

Before addressing this issue specifically, however, we briefly consider another issue, which overlaps the property/liability distinction: the appropriate scope of the property or liability rule. As we have shown, the principal harm to C1 from A's representation of C2 is the danger that A will share with C2 confidences or secrets of C1. Thus, one can imagine a rule that simply prohibits (or allows) A from disclosing to C2 confidential information obtained in the C1 representation. A rule restricted to confidences, however, has several problems in the real world setting. First, in concurrent representation situations the danger of conflicting representation is not limited to the chance that A will share C1's confidences with C2, but includes the possibility that A will reduce the vigor of his representation of C1 because of his conflicting loyalties to C2 (C2 faces the same danger as regards A's loyalty to C1). A rule restricted to confidences and secrets would not cope with this vigor of representation problem. A second problem with a rule restricted to the disclosure of confidential information is that, as a practical matter, A can use C1's confidences or secrets to C1's disadvantage even if A tells C2 nothing about C1. For example, A might adopt a litigation strategy in the C2 representation based on A's knowledge of C1's confidences, without informing C2 of the substance of those confidences. One might imagine a rule requiring A to act as if A had no confidences or secrets from the C1 representation, but such a rule would impose an unrealistic, and probably impossible, burden on A to act as if he does not know something that, in fact, he does. A third problem with a rule restricted to A's disclosure of information is that it would be extremely difficult to enforce, because C1 would not be privy to A's conversations with C2. In many cases A will have the ability to inform C2 of C1's confidences and secrets without C1 ever discovering the disclosure.

Given these problems with a rule restricted to information disclosure by A, the parties might consider, in addition to an explicit rule on information disclosure, a broader rule that would bar (or, in the alternative, allow) A from representing C2. If A is prohibited from any representation of C2, then A will not display reduced vigor in the C1 representation as a result of conflicting loyalties to C2; A will not have the opportunity to use information gained in the C1 representation to the
disadvantage of CI in a subsequent representation; and A will have less of
an incentive to reveal CI's confidences to third parties.

These two types of rules—disclosure rules and representation
rules—can exist separately. For example, one can imagine that, in some
cases, A would be barred from disclosing CI's confidences or secrets to C2,
but that A would not be barred from representing C2 as long as he does
not reveal confidences. A variety of other permutations are possible. For
the most part, however, it turns out that the analyses of disclosure and
representation rules are quite similar. We will, therefore, consider
disclosure and representation rules together, although on occasion we will
distinguish them.

A. Giving A the Property Right

First, consider a regime of default rules that gives A the property
right, either as regards disclosure or as regards conflicting representation.
In this world, A could represent other parties, C2, C3, and so forth, with
interests that conflict with CI's interests, and A could tell these other
parties any of CI's secrets and confidences. CI would not be able to bar A
from doing these things and could not obtain damages from A if A did so.

This might seem like an extremely bad set of default rules, but it is
useful to note that in the absence of transactions costs, these rules could
yield an efficient result. Take the following stylized cases in which A repre-
sents C2 and discloses CI's secrets: in Case 1, A gets $10 profit and CI
loses $15; in Case 2, A gets $10 profit and CI loses $2:

<table>
<thead>
<tr>
<th></th>
<th>Case 1</th>
<th>Case 2</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>A</td>
<td>CI</td>
</tr>
<tr>
<td></td>
<td>$10</td>
<td>($15)</td>
</tr>
<tr>
<td></td>
<td>$10</td>
<td>($2)</td>
</tr>
</tbody>
</table>

In the absence of transactions costs, CI would not stand idly by while A
represented C2. Instead, CI would offer to pay A not to represent C2. In
Case 1, CI would offer some amount between $10 and $15, which A would
accept because A obtains only $10 in profit from the C2 representation; in
Case 2, CI would offer no more than $2, which A would reject. The result
is that A would represent C2 in Case 2 and would not represent C2 in Case
1. These are the socially optimal results, because social wealth is increased
by the conflicting representation in Case 2 but decreased by that same rep-
resentation in Case 1.

In the real world, however, these bargained results would not be
achieved with any reliability. Part of the problem are the transaction costs
of bargaining; CI often will not know about the A-C2 representation and,
therefore, may not be able to prevent it through bargaining. Even if CI
knows about the possible conflicting representation, CI and A may fail to
reach agreement in Case 2, even though social welfare would be enhanced
by a Cl-A agreement, because of strategic bargaining tactics by one or both parties in the presence of a high degree of uncertainty as to the values Cl and A place on the C2 representation. Moreover, Cl and A may mistakenly reach agreement in Case 1, even though social wealth would be enhanced if they did not reach agreement. For example, if Cl places an erroneously low estimate on the cost of the C2 representation, or A places an erroneously high estimate on the value of the representation, the parties may mistakenly agree that the representation not go forward even though the representation would increase net social wealth.

Aside from these bargaining problems, there is another difficulty with giving A property right in Cl's confidences. If A has the property right, A can threaten to engage in conflicting representation with C2 or to disclose Cl's confidences without actually intending to carry out the threat. In fact, A might actually seek out conflicting representations in order to make such threats credible. Alternately, A could threaten to tell Cl's secrets to C2, or to any other party who is in a position to use the information to the detriment of Cl.

Moreover, if A were given the property right, Cl would know that she faced the probability that A would threaten conflicting representation or disclosure. Knowing that she is likely to face high costs in the future if A represents conflicting clients or discloses her confidences, Cl would lower the amount she was willing to pay A in the first place. A "lemons" problem could then arise because as the fee Cl would pay goes down, the fee will tend to drive out of the market all attorneys except those who will seek to supplement their income by threatening to represent conflicting clients or disclose confidential information. If Cl is sophisticated, she will know that, as a result of the lemons problem, any attorney willing to take the amount she offers is likely to be one who will behave opportunistically, which will result in Cl's lowering still further the price she would be willing pay.

A related problem concerns the sorts of information Cl is likely to share with A. If Cl knows that any information she provides to A is likely to find its way into hostile hands, Cl will greatly curtail the scope and amount of information she provides to A even if the representation goes forward. But this would almost certainly seriously impair the process of legal advice, counsel, and compliance because if Cl does not provide A with full information about her situation, Cl might not receive fully informed advice from A about how to comply with the law or how to protect her

27. On lemons problems, see George A. Akerlof, The Market for "Lemons": Quality Uncertainty and the Market Mechanism, 84 Q.J. Econ. 488 (1970). A lemons problem occurs when a particular attribute of quality is not observable by a buyer. This forces the buyer to rely on a proxy to measure the desired quality. Because the proxy is inexact, sellers may increase their profits by substituting lower quality goods. Buyers, however, know that sellers are likely to make such substitutions and accordingly reduce the amount they are willing to pay. Because buyers pay less, suppliers of higher quality goods are driven out of the market and only inferior goods remain.
legal interests.\textsuperscript{28} In short, it appears evident that giving \( A \) the property right, either to represent \( C_2 \) or to disclose information to \( C_2 \) or some other person who can use the information to \( C_1 \)'s disadvantage, is not a rule to which the parties would routinely agree ex ante, and, accordingly, not a wise default rule for the legal system to supply in the absence of explicit agreement by the parties.

\textbf{B. Giving \( C_1 \) the Liability Right}

An alternative regime of default rules would allow \( A \) to engage in the subsequent representation of \( C_2 \) or to disclose confidences or secrets of \( C_1 \) to \( C_2 \) or other parties, subject to a requirement that \( A \) pay \( C_1 \) damages for any harm that such representation or disclosure might cause to \( C_1 \).\textsuperscript{29} Under such a liability regime, \( C_1 \) would not have the power to veto \( A \)'s subsequent representation or disclosure. No court, for example, would disqualify \( A \) for representing a conflicting interest in litigation with \( C_1 \). However, \( A \) would have to pay \( C_1 \) damages for the harm, if any, caused by the representation or disclosure.

Once again, it should be noted that this rule achieves the socially optimal result in the absence of transactions costs. Let us return to the example given above in subsection A:

\begin{align*}
\text{Case 1} & \quad \text{Case 2} \\
A & \quad \$10 \quad \$10 \\
C_1 & \quad \$(15) \quad \$(2) \\
\text{Joint} & \quad \$(5) \quad \$8
\end{align*}

In Case 2, \( A \) would realize that if he represented \( C_2 \), he would have to pay \( C_1 \) damages of \$2. \( A \) would go ahead with the representation anyway; however, \( A \) will still make a net profit of \$8 after paying \( C_1 \)'s damages. This is the socially efficient result. In Case 1, \( A \) would realize that he would have to pay \( C_1 \) damages of \$15, which would not be profitable because \( A \) makes only \$10. \( A \) would not agree to represent \( C_2 \), which again is the socially optimal result.

Things are not as simple in the real world of transactions costs, however. Determining the proper amount of damages is one obvious

\textsuperscript{28} This observation is similar to the point made by Ronald Allen, Mark Grady, Daniel Polsby, and Michael Yashko, who argued that the law protects attorney-client confidences against disclosure in court, even though the cost of doing so is that less information is made available to the legal system, because doing so encourages clients to divulge to their attorneys unfavorable information on which valid legal claims may depend. See Ronald J. Allen et al., \textit{A Positive Theory of the Attorney-Client Privilege and the Work Product Doctrine}, 19 J. Legal Stud. 359, 361 (1990).

\textsuperscript{29} The analysis in this section profited greatly from discussions with Louis Kaplow, Professor of Law, Harvard University.
difficulty with a liability rule which permits $A$ to proceed with a conflicting representation. Furthermore, when would the court determine damages—at the outset of the $C_2$ representation, or at the conclusion? If damages are determined at the outset of the $C_2$ representation, many elements of harm may not be recognized by the court because the harm will not yet have occurred. Also, other elements of damages may be recognized even though in fact $A$ and $C_2$ would not actually impose these costs on $C_1$. Thus, there is a great deal of error built into the determination of damages at the outset of the $C_2$ representation. Moreover, determining damages at the outset creates a danger of opportunism by $A$ and $C_2$: if damages are determined at the beginning of the $C_2$ representation, $A$ and $C_2$ would subsequently have an incentive to impose even greater harm on $C_1$ because, at that point, they would face no liability for doing so.

If $C_1$'s damages are determined at the end of the $C_2$ representation, the problem of overestimating or underestimating damages can be mitigated, because at the end of the process the court will be able to investigate the actual harms $C_1$ has suffered. Assessing damages after the fact also avoids the problem of opportunism by $A$ and $C_2$, because they no longer have an incentive to increase the harm to $C_1$ from the subsequent representation, and they will have to account for all the harm they cause once the $C_2$ representation terminates. On the other hand, waiting until the end of the $C_2$ representation is also subject to difficulties. The parties probably would prefer to know sooner rather than later the extent of their potential liability. There could also be serious difficulties determining consequential damages in an ex post assessment. If $C_1$ loses a case against $C_2$, in which $A$ represents $C_2$, $C_1$ will argue that the loss was due to the conflicting representation and that, if the $A-C_2$ representation had not occurred, $C_1$ would have won the case. Should $A$ be required to pay the full amount of $C_1$'s losses from the case? How can these losses be determined, given that damages as well as liability may be in issue?

Even more troubling is the problem a court would face in determining the facts of the matter. If $C_1$ had the burden of proof on damages, $C_1$ would have to find out, for example, whether or not $A$ disclosed his confidences or secrets to $C_2$, what materials and memoranda $A$ may have prepared during the course of representing $C_2$, and what $A$ and $C_2$ discussed about litigation strategy in the subsequent case. But these are matters that fall in the heart of the traditional attorney-client and work product privileges. Opening these matters for disclosure in $C_1$'s suit for damages against $A$ could impose additional costs on $C_1$; they would also affect the initial $A-C_1$ representation because $C_1$ might reduce the amount and quality of information she tells $A$ if she fears disclosure of this information in a subsequent lawsuit.

The trier of fact can commit any of three types of error in assessing $C_1$'s damages: it can (i) systematically underestimate damages, (ii) systematically overestimate damages, or (iii) make repeated but unbiased errors across cases. In the first case (the trier of fact systematically
underestimates damages)\textsuperscript{30} we expect that \( A \) will engage in a higher level of conflicting representation, and disclose more confidences and secrets of \( C_I \), than would be socially optimal. However, the parties might attempt to bargain around this result. For example, if \( A \) and \( C_I \) both understand that the level of damages caused by \( A \)'s conflicting representation or disclosure of \( C_I \)'s confidences and secrets will be set too low in court, \( C_I \) would then have an incentive to pay \( A \) not to take on the \( C_2 \) representation by an amount equal to the difference between what \( C_I \) expects to receive in judicially awarded damages and the actual losses \( C_I \) expects to incur. This bargaining strategy would bring the liability rule closer to the rule discussed previously in which \( A \) has the property right, with the difference being that the bargaining range in this second situation is smaller. This strategy also has many of the same shortcomings as the property rule: \( A \), knowing that the liability rule would not fully compensate \( C_I \), could threaten \( C_I \) with subsequent representations or disclosures and could seek to be paid for not carrying out the threat. This would not be a situation to which the parties (\( A \) and \( C_I \)) would want to agree ex ante.

Suppose that the court systematically overestimated \( C_I \)'s damages, rather than underestimating them. Here, we can clarify the analysis by considering the following hypothetical:

<table>
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<tr>
<th></th>
<th>Case 1</th>
<th>Case 2</th>
<th>Case 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>( A )</td>
<td>$10</td>
<td>$10</td>
<td>$10</td>
</tr>
<tr>
<td>( C_I )</td>
<td>$(2)</td>
<td>$(2)</td>
<td>$(15)</td>
</tr>
<tr>
<td>Joint Product</td>
<td>$8</td>
<td>$8</td>
<td>$(5)</td>
</tr>
<tr>
<td>Damages</td>
<td>$(4)</td>
<td>$(11)</td>
<td>$(20)</td>
</tr>
</tbody>
</table>

One can see that in Case 3, \( A \) would not undertake the representation, and that there is no amount that \( A \) could pay \( C_I \) that would make it worthwhile for \( C_I \) to release any claims against \( A \). This is the socially desirable result because the joint product of the subsequent representation is negative. In Case 1, \( A \) would proceed with the representation even without bargaining with \( C_I \) because, even though the court overestimates \( C_I \)'s damages, it is still in \( A \)'s interest to proceed with the representation and pay the increased damages (\( A \) is still better off by $6). In Case 2, in the absence of bargaining \( A \) would not proceed with the \( C_2 \) representation, even though it would be socially desirable that \( A \) do so; \( A \) would have to pay $11 in damages, which exceeds \( A \)'s profit of $10 from the \( C_2 \) representation. If bargaining is allowed, however, \( A \) could offer \( C_I \) an amount between $2 and $10 for a release of \( C_I \)'s claim against \( A \) in connection with the \( C_2 \)

\textsuperscript{30} A judge or jury might systematically underestimate damages if, for example, the rules of the jurisdiction exclude forms of consequential damages that could not be proven with a high degree of confidence or if the jurisdiction limited \( C_I \)'s ability to recover damages for nonpecuniary losses that might flow from \( A \)'s disclosures of \( C_I \)'s confidences.
representation, an offer which would be in Cl's interest to accept. If the bargain were struck, the C2 representation would go forward, which is the socially efficient result. However, this result would only be possible through bargaining ex ante; once the court has awarded the damages of $11, Cl will not accept anything less than $11 to release the claim.

But in bargaining ex ante, the parties may not have good information about the amount of overage the court will award. This factor may prevent the efficient bargain from being struck if optimism by one or both parties eliminates the bargaining range. Further, bargaining itself is expensive and may fail for other reasons, such as strategic posturing by the parties. We may therefore conclude that a liability rule is not a particularly effective default term for cases in which the courts systematically overestimate Cl's damages.

Finally, consider the situation in which the court makes frequent, but randomly distributed, errors as to damages. That is, on average, damages come out about right, even though there are wide variations in individual cases. Here, if the parties know, on a case-by-case basis, whether the error is likely to favor A or Cl, the analysis is essentially the same as the analysis presented immediately above with respect to systematic judicial over or under estimation of Cl's damages. But if the parties cannot predict whether the court will rule in favor of A or Cl, the problems we identified with opportunism (in the case of systematic underestimation of damages) or of high transaction costs of bargaining in the shadow of litigation (in the case of systematic overestimation of damages) are not strongly present. The unpredictability of outcome, if small, will impose some costs on the parties if they are risk averse, but these costs are not likely to be great. If the unpredictability is large, however, the parties will suffer significant litigation costs in many cases, because optimism by either or both parties may prevent them from settling their cases. However, the social costs of a liability rule when judicial error is unbiased do appear to be less than the costs of such a rule when there is systematic bias either for A or for Cl.

One other factor should be considered here as well. Thus far, we have been assuming a liability rule that exactly compensates Cl for her harm. Such a rule may not be optimal, however, even if a liability rule regime is chosen, for two reasons. First, because of monitoring difficulties noted already, there will be many cases in which A represents C2 or discloses Cl's confidences, but Cl does not find out about the violation and accordingly never seeks redress. Because A will know that there is a probability that he will not get caught, A may choose to represent C2 even in situations when he would not represent C2 if he had to pay damages, because the cost of damages to A must be discounted by the probability of enforcement. This problem could be mitigated by setting the damages A had to pay at a level somewhat above the level of Cl's actual damages—although if the increase is set too high, we introduce dangers of opportunism by Cl and of over-deterrence.

A second problem with setting the damages just at the level necessary to compensate Cl for harm is that, effectively, we are allocating the entire
joint product of the representation to A.\textsuperscript{31} There is no obvious social policy reason why this should be so. One way to look at the C2 representation is to imagine that A is acting as a wholesaler of a valuable good (information) produced by CI. A resells this information to C2 when undertaking the subsequent representation. A rule restricting CI’s recovery to compensatory damages essentially deprives CI of any of the profit from the resale of the information. This rule may be undesirable because it reduces CI’s incentive to create the information in the first place.

On the other hand, under a liability regime, A would presumably compensate CI ex ante in the form of a lower fee for some of A’s profits on subsequent resale of CI’s confidences. This could give CI the appropriate incentive to develop information, provided that A can monitor CI’s behavior and insist that CI actually develop the information ex post (otherwise CI could take the money and opportunistically refuse to develop the information). Moreover, there may be some benefit to CI in giving A the entire surplus from resale, because doing so gives A the incentive to actively seek out a “buyer.” If the deal is one where CI actually wants the confidences to be sold, in hopes of getting compensated for them in an amount that exceeds the costs to CI of disclosure, then CI might want A to have the proper incentives to act as a good agent in arranging a sale.

This analysis suggests that in cases where CI is actually looking to A to seek out a buyer in the form of C2, the recovery under a liability rule should be limited to compensatory damages in order to give A the right incentives to perform the brokerage or wholesaling function effectively. In other cases, however, where CI does not wish ex ante that her confidences or secrets come out, the appropriate measure of damages might be set at an amount somewhat higher than compensatory damages, either by way of added recovery for CI, or by way of a fine or other sanction, the benefits of which accrue to the state. It is likely to be very difficult, however, to distinguish as a practical matter between cases where CI does and does not wish to sell her confidences; and, if the difficulties of drawing this distinction are great enough, it makes sense for the default rule to be one of compensatory damages coupled with an added state-imposed sanction, which avoids the inventive problems that would be caused by giving the added recovery to CI.

As the above discussion illustrates, the analysis of the pros and cons of a liability rule for attorney conflicts of interest is by no means simple. The major considerations, however, appear to be the following. First, damages are likely to be extremely difficult to quantify. This difficulty might result in fairly high transaction costs, including increased litigation costs,

\textsuperscript{31} We have assumed in this paper that A captures all the rents associated with the C2 representation; in actuality, A would share these rents with C2, so that the effect of a liability rule in which CI was entitled only to compensatory damages would be to allocate part of the joint product of the subsequent representation to C2.
increased negotiation costs, and the enhanced likelihood of litigation due to the size of the parties' settlement demands. Second, determining damages in a judicial proceeding is likely to involve the court in an examination of work product and attorney-client information, which is probably undesirable for the parties ex ante. If courts systematically underestimate CI's damages, the result will be a partial return to a property rule in which A has the right; the difficulties of opportunism by A, which we noted in the previous section of this article, return to the analysis. If courts systematically overestimate CI's damages, the result is a partial property rule in which CI has the property right; this remits the parties to a process of bargaining in the shadow of the law. Where judicial error is unbiased, these problems of opportunism and transaction costs are mitigated, but there remain the problems of risk-aversion by the parties and of how to set the level of damages given a positive probability that CI will not enforce her property right against A. These difficulties suggest that there are significant problems with a liability rule on attorney conflicts of interest. However, we cannot confidently rule out the liability rule as a default term in the attorney-client relationship until we have examined the alternative of a property rule in which CI has the property right.

C. Giving CI the Property Right

One might suppose that the most efficient solution would be simply to bar the attorney from representing C2 or from disclosing CI's confidences, subject to renegotiation ex post between A and CI. This is the equivalent of giving CI a property right in the matter. Would this property rule work better than a liability rule as a default term of the attorney-client relationship?

As with the other rules discussed in this article, vesting the property right in CI would, in the absence of transaction costs, achieve the socially efficient outcome. Return to the simple hypothetical already discussed:

<table>
<thead>
<tr>
<th>Case 1</th>
<th>Case 2</th>
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<tbody>
<tr>
<td>A</td>
<td>$10</td>
</tr>
<tr>
<td>CI</td>
<td>($15)</td>
</tr>
<tr>
<td>Joint Product</td>
<td>($5)</td>
</tr>
</tbody>
</table>

In both Case 1 and Case 2, in the absence of some form of compensation, CI would refuse A's request for permission to engage in the C2 representations, because both representations impose a cost on CI. In Case 2, however, A could offer CI some amount between $2 and $10 to allow A to go forward, which CI would accept because it would make her better off than if the representation did not go forward. In Case 1, there is no economically efficient bargaining range where A could persuade CI to agree to the C2 representation. A would represent C2 in Case 2 but not in Case 1—the socially efficient result.
CONFLICT OF INTEREST REGULATION

In the world of transaction costs, what are the pros and cons of giving the property right to CI? Vesting the property right in CI is clearly superior to the alternative property rule regime in which the right is given to A. The problems of opportunism by A and degeneration of the market for legal services due to the creation of a market for "lemons" are not present when the property right is vested in CI rather than A. A cannot credibly threaten CI with conflicting representations because CI has the absolute legal power to veto such representations. Similarly, A cannot effectively blackmail CI by threatening to reveal CI's confidences or secrets if the law prohibits such disclosure and it is enforced.

A more complex analysis is required when we compare property and liability regimes in which CI is given the legal right. Among the most significant advantages of a property rule is that CI would not have to reveal any attorney-client information. CI has the right to veto the A-C2 representation and can refuse to grant permission to A to disclose any attorney-client information, without providing any reason or excuse. Because information developed in the A-CI relationship would not have to be judicially investigated and quantified under the property rule regime, this potential difficulty is avoided.

Another potential advantage of a property rule is that, in some situations, it can reduce the transaction costs incident to A and CI reaching efficient bargains about subsequent representations. In the case of a liability rule, the court may be called on to determine the amount of CI's damages. But, as we have seen, there are significant difficulties in judicially quantifying the harm to CI. In the case of a property regime, on the other hand, CI will have the sole power to determine the extent of compensation CI wants for giving A the right to represent C2. The transaction costs for CI to determine how much she will demand in bargaining with A would appear to be considerably lower than the transaction costs for CI and A to reach a judicial determination of damages.

A property rule has an additional advantage in that it does not require the parties to settle ex ante on the basis of highly contingent future events. We have seen that in a liability regime A would effectively compensate CI ex ante for the right to engage in profitable conflicting representation and to pay CI damages for any resultant harm. The consideration received by CI would be in the form of a lower hourly fee or other compensation that A would agree to pay for the right to engage in a subsequent conflicting representation. This amount, however, would be extremely difficult for the parties to quantify, and thus A may end up overcompensating or undercompensating CI for the right to engage in future conflicts. This uncertainty is considerably minimized under a property rule because, in such a regime, A would pay nothing to CI ex ante and, therefore, would not have to guess at the value of the right to represent as-yet unknown C2s. In a property regime, A would pay CI only at the time an actual C2 representation became possible; and, in this setting, it will be easier (although still very difficult) for the parties to evaluate their respective costs and benefits from the subsequent
representation.

On the other hand, this residual difficulty in evaluating cost and benefits means that the transaction costs under a property regime would not be trivial. It is obviously misleading to compare litigation in a liability regime to the bargaining in a property regime. The overwhelming majority of cases in a liability rule regime would also be resolved through bargaining: either A would seek to strike an advance deal with CI by paying for the right to represent C2 or the parties would agree to a settlement during the course of litigation. Thus, while litigation is perhaps more likely to occur under a liability regime than a property regime, it will be most common under either system for the parties to resolve their differences by bargaining.32

Moreover, as compared with a property rule, a liability rule may be less problematic because it facilitates bargaining. The liability rule "anchors" the bargaining process at the point of CI's damages (assuming this is chosen as the appropriate point at which to measure liability). This anchor may centralize bargaining and thus reduce the likelihood that strategic considerations will prevent A and CI from striking a mutually beneficial deal.

A property rule may also be problematic because it presents the appearance but not the reality of over compensating CI for the value created in the A-C2 representation. Take the case in which the subsequent representation will earn A $10 and cost CI only $3. The bargaining range here is between $3 and $10, and CI could, in theory, hold out for the full $10 under a property regime. Intuitively it would be opportunistic for CI to hold out for the full $10, whereas it would not be opportunistic for A to hold out for the minimum payment of $3 necessary to make CI whole. The reason for this intuition is that the client in this situation, who is not in the business of making money from legal representation, would prefer a hedged position with respect to future representation to one involving the risk of undervaluing the harm caused by the A-C2 representation. The client can hedge against risk through a damage award whereas the lawyer, by taking on additional risk, has an increased incentive to seek out new work—an incentive the benefit of which can be partially remitted to CI in the form of ex ante compensation at the time of the original contract. Under this analysis, it might be in the parties' interest ex ante to agree to a term under which CI receives only compensation for any harm as a result of the subsequent representation—in effect, a liability rule rather than a property rule.

Furthermore, we have seen that, under a liability regime, the parties

32. This does not, however, appear to be a situation where effectively dividing the property right between A and CI will facilitate efficient trading between them, given the extreme difficulties in reaching an independent valuation in court. For discussion of cases where liability rules might facilitate efficient trading, see generally Ayres & Talley, Solomonic Bargaining, supra note 26 (discussing ways in which dividing the entitlement can mitigate strategic incentives to misrepresent private valuations).
might choose to delay settlement until the conclusion of the A-C2 representation in order to reduce the element of speculation in the damages calculation and to minimize the danger that A will behave opportunistically towards CI after obtaining a release from CI early in the C2 representation. In the case of a property rule, however, the parties would almost certainly want to resolve the matter at the outset of the A-C2 representation, but for somewhat different reasons. CI would prefer that the matter be addressed before A begins to represent C2 because, once the representation starts, A is likely to disclose CI's information. Once the representation begins, CI's legal right to bar A from the C2 representation would not be particularly valuable, because C2 knows the crucial information and can always obtain another lawyer. A would prefer that the matter be addressed early, because A will be expending sunk costs in the C2 representation and thus placing himself at greater and greater risk that CI will take bargaining advantage of him by threatening him with forfeiture of these sunk costs.

These considerations suggest that, in general, A and CI would prefer to resolve the question of the C2 representation early under a property rule. However, we have also seen that early resolution poses difficulties for the parties. When the parties settle early, they do so in the presence of a high degree of uncertainty about the future, and this may represent a cost to risk-averse parties and impair the bargaining process by creating the potential for bargaining breakdown due to unwarranted optimism by one or both parties. Moreover, early settlement creates the danger that A will behave opportunistically towards CI after obtaining CI's permission to the C2 representation. CI will have very little ability to monitor A's behavior once permission is granted because A will be representing a party with interests hostile to those of CI. The need to resolve the representation question early in the property rule regime appears to be a factor that might favor the liability rule over the property rule.

Another problem with a property rule is due to sunk costs by A in the event the parties fail to resolve the representation question at the outset of the A-C2 representation. In some cases, A will invest significant resources in the C2 representation before realizing that there is a conflict with CI. Assume, for example, that A engages in search costs of $5 in connection with a proposed representation before identifying a potential conflict of interest with CI. The subsequent representation is worth $10 to A, and it will impose a cost of $3 on C1. At this point, CI can demand compensation up to $10 for giving permission for the representation, because A's $5 search costs are sunk and cannot be recovered. Payment of an amount over $5 by A would make the representation a losing proposition for A. In itself, this does not indicate that the transaction will be inefficient from a social point of view, as it represents a mere wealth transfer from A to CI. However, if attorneys know ex ante that they will incur unrecoverable search costs and thus they will face the prospect of losing money as a result of the need to obtain permission from the first client, they will either impose these costs on clients at the time of the original contract in the
form of a risk premium—with all the uncertainties incident to calculating such a premium ex ante—or they will reduce their willingness to engage in costly searches for new business. Either of these strategies may be socially inefficient. Note, moreover, that it is not only A who engages in search costs incident to the subsequent representation; C2 must do so as well, and these costs too will be forfeited if A does not obtain permission from C1 to engage in the representation.

Another factor worth considering is the incentive effects that a property rule would have on A's willingness to identify a "buyer" of C1's information, in cases where C1 would potentially benefit from the subsequent A-C2 representation. A liability rule with compensatory damages provides A with a strong incentive to seek out higher value users of the information, because A will be able to keep all of the surplus from a "sale" of the information which he does not share with C2. A property rule, on the other hand, offers somewhat lower incentives to A to seek out higher value users of the information, because A will have to share a substantial amount of the surplus with C1 as the price for obtaining C1's consent to the subsequent representation. If A and C1 will often have an affirmative interest in creating a joint product through a subsequent conflicting representation, this factor might weigh in favor of a liability rule rather than a property rule. However, even if C1 is willing, all other things being equal, to sell her proprietary information to a third party, C1 may not necessarily want A to be the broker (or wholesaler, depending on how A's role is characterized). The relationship between C1 and A is presumably entered into because of C1's confidence in A's legal skills, not A's skills at hawking C1's confidences to third parties. If C1 can more efficiently market the confidential information directly, or by means of a broker other than A, then considerations of motivating A to act as a diligent agent in marketing C1's information become attenuated.

Finally, problems of enforcement might be somewhat greater under a property rule than under a liability rule. Under a liability regime, even if A has to pay damages to C1, he can often make a profit from the C2 representation. Under a property regime, A may reasonably fear that C1 will appropriate more, or even all, of the surplus from the C2 representation. Rather than allow this to happen, A may elect not to inform C1 of the C2 representation, or, may even disguise his involvement with C2 in order to keep this information from C1. Because A is likely to be less compliant under a property regime, C1 is likely to have more difficulty enforcing her rights.

The foregoing comparisons of the rule giving C1 the property right with the other alternatives (giving the property right to A or giving the liability right to C1) indicate that the analysis is surprisingly complex and somewhat indeterminate. Our view is that, all things considered, a property rule favoring C1 is superior to the others. Giving the property right to A can be ruled out because of the severe opportunism problems it presents. The relevant factors also appear to support a property rule in C1 over a lia-
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bility rule for CI. Because courts do not ordinarily get involved in determining damages under a property regime, the transaction costs of the property rule are likely to be lower than under a liability rule, notwithstanding the several ways in which the liability rule may conserve on transaction costs relative to a property rule. Very significant is the fact that the property rule does not open up the A-CI relationship to judicial scrutiny—thus protecting values inherent in the protections for attorney-client confidences and secrets. Other factors considered in the above analysis—such as devising a compensation scheme that motivates A to seek out the highest valued user of CI's confidential information—will probably not play an important role in most cases of conflicting representation; when such factors do play a role, the parties can always bargain around the default rule to account for their particular needs and circumstances.

III. SOME MODIFICATIONS

So far, we have concluded that, in general, the best default rule for attorney conflicts of interest is one that gives CI the right to bar subsequent conflicting representation, subject to ex post renegotiation between attorney and client. In this section, we explore several modifications of this basic rule that might improve its operation as a default rule. It turns out that the existing rules on conflicts of interest, for the most part, operate in a way consistent with the economic analysis.

A. Threshold Exception

One problem with a contractual clause that gives CI a right to bar subsequent representation of conflicting interests by A is that it will be costly for A to contract and negotiate with CI for permission and costly for CI to consider the matter. In cases where the costs to CI from the subsequent representation can be assumed to be negligible, it may be more efficient to allow A to proceed with the representation, even though doing so may impose a slight cost on CI. For example, if it costs A $1 to seek permission from CI for a representation that will cost CI only $.50, then it would be socially inefficient to require A to seek CI's permission. Neither A nor CI would prefer a rule ex ante that required consultation and consent in this situation, given that such a rule reduces the joint product of the parties. This analysis suggests that the general rule ought to be qualified by a term that allows A to proceed with representation of C2 in cases where the harm to CI is likely to be slight.

While the parties would probably agree, ex ante, to allow A to proceed with representation when the harm to CI is slight, this rule would create potential problems as it would be up to A to determine whether or not the harm to CI is in fact "slight." A may not have full information about CI's affairs and so may decide in good faith that CI would only be slightly harmed by the C2 representation, when in fact CI might be significantly harmed by the representation. In addition, A will not always act in good faith. If A wants to represent C2 without having to seek CI's
permission (and, potentially, having to pay $C1$ for the right to engage in the subsequent representation), $A$ may decide to proceed as if the harm to $C1$ is slight, even though $A$ knows that it is not slight.

These problems will tend to arise only in marginal cases. In many cases, it will be perfectly clear that either the harm to $C1$ from the $C2$ representation is, in fact, slight, or that the harm to $C1$ is substantial. When $A$ represents $C2$, even though $A$ knows or reasonably should know that the harm to $C1$ is substantial, $A$ should not be able to take advantage of a threshold exception to the property rule; by the same token, where it is clear that the harm to $C1$ is indeed slight, $C1$ should not be able to interpose an objection to the $A-C2$ representation. In close cases, however, the uncertainty as to when the threshold rule should come into play can pose problems. There is no easy solution to these difficulties. However, that there may be difficulties in close cases does not in itself rule out a threshold rule allowing $A$ to proceed with the $C2$ representation when the harm to $C1$ is slight.

A more difficult question is whether there should also be a threshold exception to disclosure. One can imagine a default rule that permits $A$ to proceed with the $C2$ representation when the harm to $C1$ is slight, but that nevertheless bars $A$ from disclosing $C1$'s confidences or secrets during the course of this representation, even when $A$ believes that the harm to $C1$ from disclosure would also be slight. There could be several reasons for this distinction. First, because $A$ will often lack information about the importance to $C1$ of information $A$ has obtained in the $C1$ representation, $A$ may often be in error as to whether or not the harm to $C1$ of divulging the information is slight. Because $A$ will tend to shade his judgment in favor of the conclusion that the harm to $C1$ is in fact slight, it may be better simply to bar any disclosure of attorney-client information in the absence of $C1$'s consent. Additionally, the $A-C2$ representation reflects the input of $A$'s labor and experience plus the value added by the prior representation of $C1$. In contrast, if $A$ discloses a confidence or secret of $C1$, the only value from the disclosure is the value that $C1$ has created in generating the information. Thus, there would appear to be less social harm in preventing $A$ from divulging $C1$'s confidences or secrets in situations where $C1$ has not consented than in preventing $A$ from working on the matter altogether.

Another value of an absolute rule against disclosure, coupled with a threshold rule on representation, is that disclosure is potentially more dangerous and harder to prevent. Disclosure can happen very quickly, and once a secret is out, it cannot be taken back. Representation, on the other hand, occurs over time and, if the representation is inappropriate, can be

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33. One approach might be to require $A$ to inform $C1$ of the $C2$ representation in all close cases, without giving $C1$ the power to veto the representation; $C1$ would then have the burden of convincing $A$ that the harm to $C1$ is more than slight or of seeking judicial relief if $A$ continues with the representation.
stopped. Thus, a more stringent rule on disclosure, as compared with the rule on representation, may be warranted.

Finally, recall that if \( A \) fully complies with a rule banning disclosure, there will be little harm to \( C_1 \) from the \( C_2 \) representation (except in concurrent representation situations where the vigor of representation may be an issue). As we have seen, however, it will be difficult to police the rule prohibiting disclosure if \( A \) represents \( C_2 \), and, when the harm to \( C_1 \) from the \( C_2 \) representation is likely to be substantial; thus, a prophylactic rule on representation is warranted. When the harm to \( C_1 \) from the \( C_2 \) representation is not likely to be substantial, however, it may not be necessary to bar subsequent representation provided that the attorney continues to operate under an obligation not to reveal \( C_1 \)'s confidences and secrets without permission. We may assume that due to monitoring and enforcement problems, \( A \) will often disclose \( C_1 \)'s confidences or use \( C_1 \)'s confidences to her disadvantage in the \( C_2 \) representation. If the harm from the \( C_2 \) representation is only slight, however, the danger that \( A \) will disobey the injunction against disclosure may be sufficiently low as to remove the need for a prophylactic rule on representation in this setting.

In conclusion, the analysis is again not straightforward and is subject to competing inferences. It appears most reasonable that there should be a threshold exception to the property rule on representation—\( A \) should be allowed to represent \( C_2 \) without \( C_1 \)'s permission when the harm to \( C_1 \) from the \( C_2 \) representation is slight. However, a property rule should apply across the board on the question of disclosure, so that \( A \) cannot disclose \( C_1 \)'s confidences or secrets to \( C_2 \) without \( C_1 \)'s consent, even when the harm to \( C_1 \) from the disclosure is only slight.

**B. Rules to Combat Opportunism**

Another modification to the rule prohibiting \( A \) from representing \( C_2 \) without \( C_1 \)'s consent might take account of the danger of opportunism. As previously noted, there are two dangers here. First, consider a case in which \( A \) will get a rent of $10 from the \( C_2 \) representation, \( C_1 \) will incur a loss of $3, and \( A \) has already spent $5 in investigation costs. \( C_1 \) could hold out for the full $10 of \( A \)'s rent before allowing \( A \) to proceed,\(^{34}\) but this would be inefficient because \( A \) would incur a loss of $5; ex ante, knowing of the potential loss, \( A \) would demand to be compensated by \( C_1 \) for the risk of loss and would engage in an inefficient, low level of search for new business. One could imagine a rule that would allow \( A \) to go forward with the \( C_2 \) representation when \( A \) has incurred significant sunk costs in

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\(^{34}\) This case differs from the standard franchising problem in which one of the parties to the franchise contract may be able opportunistically to expropriate the other's sunk costs to the party's own advantage; here, \( C_1 \) is not seeking to expropriate the value of the sunk costs but only threatening to cause \( A \) to forfeit it. See generally Gillian Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 Stan. L. Rev. 927 (1990) (discussing problems of opportunism in the law of contracts).
investigating the C2 matter, but this would be subject to the serious drawback that it would give A an incentive to incur sunk costs in order to strip C1 of her property right.

A less sweeping rule would allow A to go forward only if the harm to C1 from the C2 representation is slight—the same rule that appears to be advisable as a means for reducing transactions costs where the harm involved is small. This rule appears well crafted to deal with the sunk cost problem as well, because, in most cases in which A has expended significant sunk costs on the C2 matter before discovering a conflict with C1, the harm to C1 from the C2 representation is likely to be slight (otherwise A likely would have identified the existence of a conflict earlier). We conclude, therefore, that a threshold exception to a liability rule can be of help in addressing the sunk cost problem as well.

The second case to consider is one where C1 has notice of A's representation but sits on her rights until A has incurred significant sunk costs and then interposes an objection to the C2 representation. C1's delay in this situation is quite clearly for opportunistic motives because, by waiting until A has incurred large sunk costs, C1 can obtain greater bargaining leverage in the negotiations over consent to the C2 representation. There would be good reason for the parties to stipulate ex ante that C1's failure to act constitutes a waiver. Ex ante, both C1 and A would agree to prohibit such behavior because it represents a negative joint product, or at least a lower than optimal joint product, that can easily be avoided if C1 does not sit on her rights.

C. Additional Sanction for Noncompliance

A third modification of the simple property rule would be for the law to specify penalties for A's violation of the default rule, above and beyond the availability of an order disqualifying A from continuing to represent C2. There are at least two reasons why additional sanctions might be advisable. First, if A has disclosed C1's confidences or secrets to C2, a judicial order of disqualification will do little to help C1 and may not deter A because A may have already been paid for the information. Unless A fears a sanction in addition to disqualification, A will have an incentive to disclose C1's confidences and secrets early in order to receive compensation before being required to leave the case. Second, as we have seen, rules regulating A's representation or disclosure of information to C2 are hard to enforce as C1 does not directly monitor A's conduct. The probability of detection is not high, especially because A can disguise his participation in a case by acting as a consultant whose name does not appear on court papers or other documents. If A believes there is a substantial probability

35. This is not necessarily true, of course; as Stephen Gillers pointed out, attorneys are sometimes sloppy, and even if they do due exercise diligence beforehand, they may not fully understand the conflict rules or the harm against which they protect the former client. Memorandum from Stephen Gillers, supra note 25, at 4.
that he will be able to represent C2 or disclose CI's information without being detected, A will likely do so, notwithstanding the presence of rules prohibiting such representation or disclosure, unless the state supplies an additional sanction for A's misconduct.

These considerations suggest that in addition to disqualification, A should fear an additional sanction. What form this sanction should take is a different question. It could take the form of greater-than-compensatory money damages in cases where disqualification alone will not make CI whole. The sanction could take the form of a fine or other penalty imposed by the state, the benefits of which, if any, would not go to CI. Perhaps even more effectively, the sanction could be in the form of reputation loss (and thus the resultant loss of business) to an attorney who engages in an inappropriate conflict of interest representation under the existing rules. If A and CI had the ability to do so, they would probably agree ex ante to the establishment of such an additional sanctioning regime.

IV. THE MODEL RULES AND THE MODEL CODE

The analysis of the appropriate background rule so far suggests that, in general, the attorney and client would ordinarily agree—subject to reasonable terms designed to deal with threshold situations, client opportunism, and sanctions for violations—that (i) A will not undertake a conflicting representation without the consent of CI, and (ii) A will not disclose or use adversely to CI information obtained during the representation. This represents the general pattern observed in the Model Rules of Professional Conduct and the Model Code of Professional Responsibility, both of which were drafted by the American Bar Association, which impose upon the attorney a strict duty of confidentiality and generally prohibit the representation of conflicting interests without the consent of the client. It appears that in broad pattern the Model Rules and the Model Code are quite consistent with reasonable inferences about economic efficiency.
What about the conclusions reached in this paper, that the background rule allowing \( CI \) to prohibit \( A \) from conflicting representation should apply only beyond a certain threshold of harm to \( CI \) in order to economize on transaction costs and to police against opportunistic behavior by \( CI \)? The ethics rules do not contain an explicit threshold exception of this sort, but they can be interpreted according to a rule of reason that permits representation to go forward without \( CI \)'s consent when the harm to \( CI \) is not substantial. Thus, if the differences between \( CI \) and \( C2 \) are not sufficiently concrete to rise to the level of a conflict, the rules do not apply. Model Rule 1.7(a) provides, for example, that, in general, "[a] lawyer shall not represent a client if the representation of that client will be directly adverse to another client."43 If the representation is not directly adverse to \( CI \), but only slightly in tension, impliedly the attorney can proceed without obtaining \( CI \)'s consent—even though there is a possibility that the interest of \( CI \) may be harmed by the second representation."44 This is, in effect, a threshold exception to the rule requiring \( CI \)'s permission to the representation, and it appears to be quite

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43. Model Rules of Professional Conduct Rule 1.7(a) (1983). To like effect is the Model Code, which provides in Disciplinary Rule 5-101(a) that "[e]xcept with the consent of his client after full disclosure, a lawyer shall not accept employment if the exercise of his professional judgment on behalf of his client will be or reasonably may be affected by his own financial, business, property, or personal interests." Model Code of Professional Responsibility DR 5-101(a) (1981). DR 5-105(A) provides that

[a] lawyer shall decline proffered employment if the exercise of his independent professional judgment in behalf of a client will be or is likely to be adversely affected by the acceptance of the proffered employment, or if it would be likely to involve him in representing differing interests, except to the extent permitted under DR 5-105(C).

Model Code of Professional Responsibility DR 5-105(A) (1981). DR 5-105(C) provides that "a lawyer may represent multiple clients if it is obvious that he can adequately represent the interest of each and if each consents to the representation after full disclosure of the possible effect of such representation on the exercise of his independent professional judgment on behalf of each." Model Code of Professional Responsibility DR 5-105(C) (1981).

44. Not all ethics scholars would agree with the proposition that the Model Rules refer implicitly to a continuum of harms and apply only when the quantum of harm reaches a sufficiently high level. Stephen Gillers, for example, argued in comments to this paper that the Rules adopt a categorical, rather than a quantitative, approach. See Memorandum from Stephen Gillers, supra note 25, at 5-7. We believe this objection is largely semantic. Even if the rules attempt to establish a categorical approach, their effect is going to be quantitative: when the degree of conflict becomes severe enough, the rule applies; otherwise, it does not.
a reasonable rule given the analysis of optimal default terms presented above. On the other hand, parallel to the default term which we have argued is optimal, the Model Rules and the Model Code do not appear to contain any threshold exception for disclosure (as opposed to representation). The attorney is barred from disclosing confidences or secrets of his client (or former client) even if the representation in which the attorney is engaged does not rise to the level of a conflict. If A's disclosure of a client confidence or secret is truly de minimis, it may be unlikely to constitute grounds for formal disciplinary proceedings, but it is nevertheless a violation of the disciplinary rules.

Similarly, the comments to the Model Code and the Model Rules also distinguish rather sharply between litigation and negotiation settings. This distinction makes sense from the standpoint of default rule analysis. In the negotiation setting, both clients are attempting to create value through a process of bargaining which they hope will generate substantial benefits for each of them. Their interests are aligned in that each wants to increase the size of the overall pie, even though they also have a conflict of interest in that each wants as big a share as possible of the wealth so created. Because of the substantial alignment of interests in the negotiation setting, the dangers of harm to CI from the attorney who is also representing C2, a party in negotiation with CI, may not be as great as would be the case in a litigation setting in which the parties are fighting over the division of a fixed (or shrinking) pie with little or no alignment of interests. Thus, negotiations are more likely to fall below the consent threshold than is litigation.

Another factor of importance in the negotiation setting is the role assigned to the attorney. If A is functioning essentially as a scrivener, recording in proper legal form an agreement being negotiated by the parties on their own, there is little danger of harm to C1 from joint representation. By contrast, if A was charged by one or both parties with substantive authority for conducting the negotiation or with providing business advice on the terms of the deal, the risk of harm to C1 increases. To the degree that the lawyer's role becomes merely technical, there is a reduced danger of harm to the clients from multiple representation and

45. Rule 1.7(a)(1) guards against this problem, to an extent, with the requirement that the lawyer must reasonably believe that "the representation will not adversely affect the relationship with the other client," Model Rules of Professional Conduct Rule 1.7(a)(1) (1983), but this does not rule out cases in which the first client's interests could potentially be harmed by the representation, so long as the lawyer reasonably believes that they will not be harmed. See also Model Rules of Professional Conduct Rule 1.7 cmt. ¶ 7 (1983) ("Common representation of persons having similar interests is proper if the risk of adverse effect is minimal . . . .").


an increased likelihood that a given case will fall below the consent threshold.

The rules on conflicts within law firms also appear to be generally consistent with economic theory. With respect to concurrent conflicts, the rule is one of absolute imputed disqualification: disqualification of any attorney in a firm disqualifies the entire firm.\(^\text{48}\) This rule makes a great deal of sense for a small law office, with four or five lawyers. It makes less sense for a very large law firm, especially one with offices in different cities or countries and sophisticated procedures in place for maintaining confidentiality within the firm as well as between the firm and the outside world. At some point, the damage to \(C_1\) from a firm representing \(C_2\) may become attenuated when the firm is very large in size,\(^\text{49}\) the attorney who is working for \(C_2\) is different from the attorney working for \(C_1\), and proper procedures for maintaining confidentiality of information in the two representations are followed. However, it does not appear unreasonable to maintain a rule of imputed disqualification even in large firm cases, given the absence of efficiency losses and the difficulty of identifying situations where the danger to \(C_1\) is sufficiently attenuated as to fall below the relevant threshold. In this context, it is also relevant that, in the large, multi-office law firm, the efficiency gains from allowing \(A\)'s firm to represent \(C_2\) are often nonexistent. Specifically, when the attorney working on \(C_2\)'s matter is physically separated from the attorney in the firm who worked on \(C_1\)'s matter then any generic legal skills that the firm acquired in representing \(C_1\) will not benefit \(C_2\). In particular, in the large, multi-office law-firm context, there will be no cost savings to \(C_2\) from the fact that another lawyer in the same firm previously represented \(C_1\). Because, obviously, if the lawyers are in different offices and are not working together, the human capital skills that were developed in one office are not going to be transferred to the lawyers in the other office. One implication of this is that as the damages to \(C_1\) from the subsequent representation of \(C_2\) becomes more attenuated, so too do the gains to \(A\) from such subsequent representations.

The ethics codes also adopt what appears to be a rather sensible default rule in such situations. If \(A\)'s representation of \(C_1\) has terminated, and \(A\) subsequently considers a representation of \(C_2\), whose interests conflict with \(C_1\), there is clearly a danger that the second representation will harm \(C_1\)'s interests. Thus, some rule of disqualification should apply. However, the dangers of conflict are considerably lower in this situation than in the simultaneous representation context because the information \(A\)

\(^{48}\) See Model Rules Rule 1.10 ("While lawyers are associated in a firm, none of them shall knowingly represent a client when any one of them practicing alone would be prohibited from doing so . . ."); Model Code DR 5-105(D) ("If a lawyer is required to decline employment or to withdraw from employment under a Disciplinary Rule, no partner, or associate, or any other lawyer affiliated with him or his firm, may accept or continue such employment.").

CONFLICT OF INTEREST REGULATION

has about CI is going to become quickly outdated. The rules capture this effect fairly well by providing that "[a] lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client unless the former client consents after consultation." The comments to the rule make clear that the term "substantially related" refers to the specific facts of the former representation, not to general similarities in fact or law. Although the rule is not explicitly tied to the fact that the quality of information deteriorates over time, this is its practical effect, as, over time, circumstances are likely to change sufficiently as to make the subsequent representation not substantially related to the former representation.

When it comes to the movement of attorneys from firm to firm, the rules regarding conflicting representations are sensibly less stringent than the rule of absolute imputed disqualification that applies in the single-firm context. As a practical matter, if one attorney from a large firm carried all the firm's conflicts with him when he moved to a different firm, the costs to the second firm of hiring that attorney would be enormous because the second firm would have to turn away much more work on conflicts grounds. A rule of absolute disqualification would thus greatly impair the market for lateral hiring of attorneys. Not only would the rule impose a significant cost on the attorney, but it would also reduce the efficiency of the legal services market as a whole. Moreover, in most cases, CI has little to fear if the attorney in question has not, while at the first law firm, personally worked on any issue involving CI. Under the imputed disqualification rule, A would be barred from representing C2 while at the first firm, whereas there is no significant danger to CI if the new firm represents C2—even if A himself is assigned to work on the new representation. If A had no involvement with CI's affairs while at the former firm, there is little danger that he will carry with him information damaging to CI when he changes firms. The parties, therefore, would not agree ex ante to the application of an imputed disqualification rule in the case of A moving between firms because A has much more to lose from such a rule than CI has to gain.

On the other hand, CI does risk incurring significant costs if A has worked on CI's matters, or otherwise gained actual knowledge about CI's affairs, while working at the former firm and then moves to a firm that represents C2. In such a case, it may be presumed that A does carry

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52. In arguing that the deteriorating quality of information is important in the functioning of the rule, we do not mean to say that the rule should be understood to reflect solely this consideration. As Stephen Gillers has pointed out, the rule also protects clients against the danger that their lawyer will subsequently turn on them in a matter related to the former representation, and thus enhances client confidence in attorneys ex ante. See Memorandum from Stephen Gillers, supra note 25, at 6-7.
information potentially damaging to CI when he moves, and the parties, ex ante, would likely agree that CI should have veto power over the new firm's continuing to represent C2 in such circumstances. However, because A will no longer have access to CI's files, and because the value of information in A's hands deteriorates over time, the risks associated with subsequent representation are less when the attorney has moved than when he remains at his former firm. One might legitimately question the efficiency of the rule of absolute disqualification of the second firm in this case. If A's new firm implements procedures to control the transfer of confidential information about the CI representation between A and other attorneys at the firm, and, if A is barred from any participation in the C2 representation at the new firm, it might be more efficient to allow the new firm to represent C2, subject to the creation of adequate firewalls to control the risk to CI due to A's prior representation.

The Model Rules adjust these competing considerations in a sensible fashion, providing that

[a] lawyer shall not knowingly represent a person in the same or a substantially related matter in which the firm with which the lawyer formerly was associated had previously represented a client

(1) whose interests are materially adverse to that person;
and

(2) about whom the lawyer had acquired [confidential] information . . . that is material to the matter;

unless the former client consents after consultation.53

The analysis presented above suggests that this is exactly the type of rule that A and CI would agree to if they were bargaining about the matter ex ante.

We also concluded that, as a theoretical matter, CI should not be able to assert the right to bar an attorney from a case if CI has deliberately delayed interposing an objection in order to achieve economic leverage against the attorney (or, more realistically in most cases, against the attorney's current client). This appears to be consonant with current practice, under which courts facing disqualification motions in litigation are increasingly skeptical about the bona fides of the parties seeking disqualification and increasingly attuned to the possibility that the disqualification motion is being used for strategic purposes, rather than to protect the former client against a real and substantial risk of harm.54

Finally, we concluded that an optimal system of default rules would include sanctions in addition to disqualifying A if he inappropriately repre-

sents C2 without CI's consent. The rules of legal ethics do in fact impose such an additional level of sanctions, as the attorney found to have engaged in an impermissible conflict of interest is subject to serious penalties, including loss of reputation, license suspension, or even disbarment—sanctions sufficient to make attorneys think twice about engaging in inappropriate conflicts of interest or disclosing client secrets or confidences to third parties.

In general, therefore, economic analysis suggests that the current rules of attorney ethics are efficient rules to which the parties would agree if they were to bargain ex ante. However, there are two respects in which the conflicts of interest rules, or the overall regime in which the rules are understood, might be critiqued from an economic perspective. First, the professional codes are to some extent in conflict with the economic analysis in their treatment of consent. Nothing in the rules suggests that C1 and A are expected to engage in negotiation for consent to subsequent representations. The implicit model is one in which A approaches C1 and asks for permission. One might wonder, however, why C1 would grant this permission, thereby giving up a potentially valuable asset (the right to bar A from representing C2) without receiving something of value in return. The relationship between lawyer and client is, in many cases, strictly a matter of business, often big business—the lawyer or law firm may bill the client for millions of dollars a year. It would appear unrealistic to expect that clients dealing at arm's length with lawyers—especially, as will often be the case in conflict of interest situations, lawyers who no longer represent them—will simply give away this valuable asset very often.55

The idea that attorneys should be allowed to pay clients for the right to engage in conflicting representation might seem grossly inappropriate from the standpoint of traditional conceptions of the lawyer's role. The fact of the matter, however, is that if the attorney is not allowed to pay directly, one of two inefficient events is likely to happen: either A will pay indirectly, for example, by acknowledging to CI that he "owes him one" and by performing favors or below-cost services for CI in the future, or A will not seek CI's permission and simply conduct the subsequent representation, on the theory that CI would probably deny it. Neither of these outcomes is particularly desirable, especially because an efficient outcome can be achieved with a market approach. One of our recommendations for reform is to more explicitly recognize the utility of a market-based solution to the conflict of interest problem. It should be considered appropriate for attorneys to compensate their clients or former clients for the right to engage in conflicting representation of other clients.

55. It may be that, in a particular industry, companies would adopt the practice of giving permission pursuant to an industry-wide norm that such permissions are ordinarily granted. Such practices may currently exist, although we do not know of any; however, they are likely to prove unstable over time because of the temptations firms will face to opt out of the practice in order to obtain compensation from attorneys.
A second aspect of the current rules that might be challenged from an economic perspective is their implication that some conflicts of interest are so severe that even a fully informed, rational, and sophisticated client could never effectively consent to them. Model Code DR 5-105(C) goes farthest in this direction, requiring that it be "obvious" that A "can adequately represent the interest of each [client]." 56 Apparently, under the Model Code, it would not be enough for both clients to consent after full disclosure and due deliberation unless it was also "obvious" that A can adequately represent both. Aside from the defects of draftsmanship here—When is something "obvious"? To whom must it be "obvious"?—this provision goes too far in the direction of imposing a mandatory term, rather than respecting the agreement of the parties. If the parties have made a full, free and voluntary choice to allow a subsequent representation, notwithstanding the presence of a conflict of interest, it should be conclusively presumed that the representation can proceed, at least in the absence of significant third-party effects.

The newer Model Rules mitigate this flaw, but they do not eliminate it entirely. The Model Rules drop the unfortunate "obvious" language, but still maintain a provision that can bar representation independently of client consent: not only must CJ consent after consultation, but it must also be the case that A "reasonably believes the representation will not adversely affect the relationship with the other client." 57 It is doubtful that this provision has much bite, however, as it still leaves the determination up to A and requires only that A have a reasonable belief. Nevertheless, there remains the possibility that this clause could be used to challenge a subsequent representation that had been fully and voluntarily agreed to by the parties, on the ground that A's belief that no conflicts of interest exist was not "reasonable." It is difficult to justify this rule in economic terms, however, especially given the fruitful opportunities it seems to offer for ex post opportunism on the part of unscrupulous clients. 58

CONCLUSION

In the conflicts of interest area, the applicable ethics rules adopt a remarkably sensible system of background rules to govern the attorney-client relationship, subject only to a number of quibbles which, while not insignificant, are relatively minor in the scheme of things. Why would the bar—a group of attorneys—promote and enforce a system of regulation so

58. Stephen Gillers observed that there may be greater justification for a rule of nonwaivable conflicts in the criminal context, namely whether a defendant may want to waive a conflict that would threaten the integrity of a verdict by impeaching the independence of counsel. Memorandum from Stephen Gillers, supra note 25, at 8-9. This is a valid point, but it is limited in scope to certain criminal contexts and does not affect the general run of cases treated in this paper.
apparently consonant with the public interest? Simply because, in this matter, the bar's interests are generally aligned with the interests of the public at large. We may assume that very few attorneys have an interest in systematically harming clients by engaging in conflict of interest representations to which the clients would not agree ex ante. There is little constituency in the bar in favor of a system of conflicts regulations that deviate systematically from the optimal default rules. Quite to the contrary, most lawyers would prefer a regulatory system that adopted reasonable default rules in the area of conflicts of interest, as such rules increase the joint product of the attorney-client relationship—an increase in wealth in which attorneys as well as clients can share. Effectively, the existing conflict of interest rules reduce the costs of attorney-client contracting by supplying reasonably efficient default rules that apply in case the parties have not specified the terms of their agreement on the point.

Where the rules deviate most clearly from economic efficiency, we may speculate that the bar gains more in public relations than it loses in revenues. It is doubtful that these rules have much real-world impact; there are very few cases where a representation was found to be inappropriate notwithstanding the client's informed consent. On the other hand, having these paternalistic-sounding rules in place reflects the bar's concern for the public welfare, and thus provides some defense to the widespread public belief that attorneys routinely take undue advantage of their clients.

What remains somewhat mysterious to us is why we do not seem to observe more instances of market transactions in which attorneys pay clients for the privilege of engaging in a conflicting regulation. Although such a market would face obstacles to effective operation—negotiating a price may be difficult, and it may be awkward for an attorney and client to bargain with each other in a situation in which their interests have become adversarial—these difficulties do not appear insurmountable. For example, the parties could agree ex ante to appoint a trusted neutral party who would be charged with determining the price, if any, that the client would charge for granting permission to engage in the representation. We imagine that deals of this type are sometimes struck (perhaps, with C2, rather than A, performing the bargaining), but that when they are reached, the parties do not publicize them. These deals probably take the form of an implicit promise for a return of a favor, rather than an explicit market transaction with cash compensation. Alternatively, C2 may agree to give up or settle claims against C1 in exchange for C1's permission to the representation. Exploring the frequency with which such transactions occur and the terms negotiated by the parties might be a fruitful avenue for future research.