BUREAU OF COMPETITION

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

March 26, 1991

George Kuhlman
Ethics Counsel
American Bar Association
541 N. Fairbanks Court, 14th Floor
Chicago, IL 60611

Dear Mr. Kuhlman:

The staff of the Bureau of Competition is pleased to respond to your request for our views on the competitive effects of proposed amendments to the American Bar Association's Model Rules of Professional Conduct to address possible problems with attorney operation of ancillary businesses.[1] As we discuss below, we support the approach that the Standing Committee on Ethics and Professional Responsibility Discussion Draft proposes: narrowly tailored rules addressing the specific problems associated with the provision of ancillary services by law firms.[2] This approach avoids rules that broadly limit the service options available to consumers.

We will first describe the FTC staff's interest and previous experience in this field. Next, we will summarize the proposals that the ABA is considering. We will then discuss how law firm diversification generally benefits consumers. Finally, we will analyze some of the objections to law firm diversification.

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[1] Memorandum from Helaine Barnett, Chair, Standing Committee on Ethics and Professional Responsibility, re Discussion Draft of Proposed Revisions to the Model Rules of Professional Conduct Governing Lawyers' Ancillary Businesses (January 10, 1991) ("Discussion Draft"); ABA Standing Committee on Ethics and Professional Responsibility, Ancillary Business Hearing/February 8, 1991 - Seattle, Washington/Some Issues for Consideration.

[2] These comments are the views of the staff of the Bureau of Competition of the Federal Trade Commission. They are not necessarily the views of the Commission or of any individual Commissioner.

The Interest and Experience of the Staff of the FTC

Congress has empowered the Federal Trade Commission to prevent unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce. 15 U.S.C. § 41, et seq. Pursuant to this statutory mandate, the Commission and its staff encourage members of licensed professions to compete to the extent competition is compatible with other legitimate goals.[3] For several years, the Commission and its staff, through law enforcement proceedings[4] and studies,[5] have been evaluating the

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[3] For example, the Commission's staff has commented to state governments and professional societies on the regulation of professionals, including attorneys. E.g., Staff Comments on the Arizona Rules of Professional Conduct (April 17, 1990); Staff Comments on the Rules of Professional Conduct of the Florida Supreme Court (July 17, 1989); Staff Comments on the American Bar Association Model Rules of Professional Conduct (November 22, 1988); Staff Comments on the Rules of Professional Conduct of the New Jersey Supreme Court, (November 9, 1987); Staff Comments on the Code of Professional Responsibility of the Alabama State Bar (March 31, 1987).

At least two staff comments have addressed the issue of diversification in other professional services markets. Letter to the Honorable Chuck Hardwick, Speaker of the New Jersey Assembly (May 21, 1987) (regarding proposed legislation to prohibit physicians from having financial interests in physical therapy practices); Letter to Lin Ng, Nevada Deputy Attorney General (October 23, 1986) (regarding proposed Nevada State Board of Physical Therapy prohibition on physician employment of physical therapists).

[4] Massachusetts Board of Registration in Optometry, 110 F.T.C. 549, 600 (1988); Rhode Island Board of Accountancy, 107 F.T.C. 293 (1986) (consent order); Louisiana State Board of Dentistry, 106 F.T.C. 65 (1985) (consent order); American Medical Association, 94 F.T.C. 701, aff'd, 638 F.2d 442 (2d Cir. 1980), aff'd mem. by equally divided Court, 455 U.S. 676 (1982) ("AMA"); American Institute of Certified Public Accountants, C-3297 (July 26, 1990) (consent order). We recognize that the ABA Model Rules purport to be recommendations only and not to restrict ABA members. Each state adopts enforceable rules governing the practice of law, which may to a greater or lesser extent reflect the Model Rules.

[5] E.g., C. Cox & S. Foster, The Costs and Benefits of Occupational Regulation (FTC Bureau of Economics 1990); W. Jacobs, et al., Improving Consumer Access to Legal Services: The Case for Removing Restrictions on Truthful Advertising (FTC Staff Report 1984).

competitive effects of public and private restrictions on the business practices of state-licensed professionals, including lawyers, dentists, optometrists, and physicians. Our goal has been to determine whether particular restrictions impede competition or increase costs without providing countervailing benefits to consumers.

Proposed Responses to Law Firm Diversification

As commercial transactions have become more complex, clients have required the services of non-lawyer professionals -- including investment bankers, economists, and accountants -- to assist in areas where lawyers have traditionally played a primary role. Law firms are generally free to provide non-legal services, and some firms have found it advantageous to employ or associate with these professionals. Clients are therefore increasingly able to purchase both legal and non-legal services from one source. Law firms have also started providing these non-legal services to persons who are not legal clients. Some ABA members are concerned that such law firm diversification can create several potential problems, including conflicts of interest, loss of client confidentiality, encouragement of the unauthorized practice of law, and customer confusion as to the lawyer's role. E.g., Discussion Draft, at 3.

In response to these concerns, the ABA Litigation Section has proposed to bar firms from providing ancillary services except to their legal services clients. Further, the Section would permit the provision of ancillary services only to the extent that such services are "incidental to, in connection with and concurrent to" legal services.[6]

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[6] Recommendation and Report on Law Firms' Ancillary Business Activities Prepared by the Section of Litigation of the American Bar Association, at 9-30 (February 8, 1990) ("Litigation Section Report"). The Litigation Section also proposes that the ABA reaffirm the Model Rules' general bar on non-lawyer ownership of equity interests in law firms. We do not understand the Ethics Committee to be seeking comments on this proposal and thus do not address it.

The Section originally also recommended barring law firms from providing non-legal services through separate subsidiaries and affiliates, but the Section appears to have dropped this suggestion. Letter from ABA Section of Litigation Task Force on Ancillary Business Activities to Helaine K. Barnett, Chair, Standing Committee on Ethics and Professional Responsibility, at 3 (February 5, 1991) ("Litigation Section Letter").

The Standing Committee has proposed for discussion a different approach. While acknowledging that law firm diversification may have costs, including the problems noted above, the Committee has concluded that the ABA can minimize these problems by adopting narrowly tailored changes to the ABA's Model Rules of Professional Conduct. Discussion Draft, at 2-3. The Special Coordinating Committee on Professionalism and its Working Group have reached the same conclusion.[7]

The Model Rules are designed to guide the states in their adoption of rules that educate lawyers as to their ethical responsibilities and deter them from engaging in unethical conduct that harms their clients. The Standing Committee recommends expansion of the Model Rules' protections to a new class of consumers: customers of a diversified law firm's ancillary businesses. The Committee recommends generally that such customers (who purchase only non-legal services) receive the same protections as legal clients, wherever such treatment is practical. (Where a client receives both legal and non-legal services from a firm, the Standing Committee recommends that the Model Rules treat that person as a law client as to both types of services.)

For example, in order to assure that a lawyer exercises independent professional judgment on behalf of a client, the Model Rules generally prohibit firms from simultaneously representing clients whose interests conflict. The Standing Committee proposes that customers purchasing ancillary services receive similar protections so that (a) a law firm could not provide legal services to clients whose interests conflict with customers of the firm's ancillary businesses, and (b) the firm's ancillary business could not represent customers whose interests conflict with those of other customers or clients, although a customer could waive these restrictions in some circumstances. Similarly, just as the Model Rules presently require that a law firm safeguard the secrets of a law client, the Committee also would require that the firm keep confidential any such information relating to customers of ancillary services. (The attorney-client privilege, which is independent of the Model Rules, would not apply to customers of an ancillary business; a diversified law firm would have to disclose this fact to its ancillary business customers.) Finally, the Committee would

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[7] Special Coordinating Committee on Professionalism, Special Report to the House of Delegates on Ancillary Business Activities of Lawyers and Law Firms, at 10-11 (December 1990) ("Professionalism Committee Report"); Working Group of Professionalism Committee, Final Report on the Ancillary Business Activities of Lawyers and Law Firms, at 12-16 (November 30, 1990) ("Working Group Report").

require that diversified law firms disclose to customers of their ancillary businesses the relationships between that business and the firm, and the extent to which such businesses will treat their customers as clients of the law firm. Discussion Draft, at 3-4.

Given these safeguards, the Standing Committee proposes no prohibitions on attorney operation of ancillary businesses and would permit a law firm to provide non-legal services to customers that are not legal clients of the firm. The Committee notes that consumers could benefit from attorney provision of ancillary services and that it "was not aware of any history or evidence of any abuse or harm to the public arising from lawyers' participation in ancillary business activities." Discussion Draft, at 3. The Professionalism Committee and its Working Group agreed with these conclusions. Professionalism Committee Report, at 4; Working Group Report, at 11-12.

Benefits of Law Firm Diversification

Diversification into related services can benefit consumers by allowing firms most efficiently to provide a mix of services that consumers seek. Conversely, rules that restrict the services that firms may offer can harm consumers by restricting consumer choice.[8] There is no reason to believe that these generalizations are inapplicable to legal services markets.

Indeed, the legal profession has long provided clients with a variety of services. Many attorneys are part of multi-specialty law firms, recognizing that such firms may offer benefits to clients with complex, unusual, or diverse legal problems. For example, a lawyer specializing in real estate may be in a better position to assist a client encountering financial difficulties if he or she works for a firm with in-house bankruptcy expertise. Diversification outside of legal services also has a long history. For example, real estate attorneys have

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[8] AMA, 94 F.T.C. at 1016-18 (restrictions on joint business arrangements between physicians and non-physicians harmful because they prevented adoption of more efficient business formats). The Commission has issued two consent orders barring restrictions on diversification. See Oklahoma State Board of Veterinary Medicine, C-3283 (January 31, 1990) (prohibiting board from barring veterinarians from working for or associating with non-veterinarians); Iowa Chapter of American Physical Therapy Association, C-3242 (November 4, 1988) (prohibiting association from barring members from accepting employment from physicians).

traditionally provided escrow and title search and examination services. See, e.g., Litigation Section Report, at 11.

Diversified law firms may provide several specific benefits to consumers. First, such law firms can offer "one-stop shopping" and thereby reduce the cost to the client of searching for and receiving a variety of professional services. For example, a client that needs economic expertise may find it advantageous to use a law firm's in-house experts. Not only does the client avoid the cost of finding an economist with the relevant skills, but it may save on the costs of contracting for such services. A diversified firm may also be able to work more efficiently with its in-house experts than with experts hired on an ad hoc basis. The fact that law firms employ other professionals, and that other firms that provide professional services -- including lobbying, accounting, and economic consulting -- employ lawyers, suggests that consumers value "one stop shopping."

Second, diversified law firms can offer a distinct approach to solving legal problems. A diversified law firm may be able to analyze a client's problem from a variety of different perspectives and blend them into a comprehensive and integrated solution. In addition, lawyers in diversified firms assert that they generally have more contact with experts from other disciplines and thus have a broader perspective on legal problems.[9] Although we take no position as to whether this assertion is correct, consumers may find that such an approach could suit their needs.

Although the Litigation Section's recommendation would allow law firms to provide some of these benefits of diversification to their legal clients, its effect could limit the growth of such firms, which might impede the development of innovative forms of practice from which consumers could choose. The proposal would limit the volume of ancillary services a firm could offer by requiring that such services accompany legal services. Under this rule, a firm might not have a sufficient incentive or volume of ancillary services to justify a significant investment in their development. In addition, if highly talented non-lawyers are reluctant to work for law firms that may provide ancillary services only in connection with legal services, because such a limitation would reduce their potential customer base, then law firms may be unable to provide high quality ancillary services.

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[9] See Professional Affiliations between Lawyers and Nonlawyers, Comments submitted to ABA Special Coordinating Committee on Professionalism, from Akin, Gump, Strauss, Hauer & Feld, et al., at 11-12 (June 5, 1989).

Thus, the Section's proposal may establish obstacles to law firm diversification.

We are neither advocating that law firms provide ancillary services nor claiming that all consumers prefer firms that do. Rather, we are pointing out that law firm diversification may benefit some consumers by providing convenient and cost-effective services. Absent an offsetting risk of consumer harm, we believe that consumers will benefit if permitted to choose from an array of diversified and non-diversified law firms.

Addressing the Problems with Law Firm Diversification

There appears to be a consensus within the ABA that, absent appropriate safeguards, law firm diversification may create some risk of consumer injury. Analysts have identified two categories of concern. The Standing Committee, Professionalism Committee, Working Group, and Litigation Section all agree that certain customers of ancillary businesses may suffer harm from conflicts of interest, disclosure of confidential information, and similar abuses; the Litigation Section terms these "ethical issues." The Litigation Section, in addition, identifies a generalized problem relating to the quality and regulation of the legal profession, which it terms "professionalism concerns."[10] As we discuss below, we believe that the Standing Committee's proposals effectively address these concerns.

Ethical Issues

We agree that diversified law firms raise questions about possible conflicts of interest, loss of client confidentiality, and the unauthorized practice of law. At the same time, it is important to recognize that law firm diversification does not make it more likely that consumers will face such problems. Issues of this sort are inherent in any relationship between a professional and a client. For example, a client will want to be able to speak freely to his or her lawyer, accountant, or investment banker without fear that the professional will disclose the information or, perhaps worse, use the information to the client's detriment. There is no reason to believe that, for example, investment bankers affiliated with lawyers are more

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[10] The Litigation Section also argues that diversification threatens the financial stability of law firms. Litigation Section Report, at 16-18. Financial theory, however, generally suggests that diversification should strengthen stability, because it can make the firm less reliant on income derived from any one source. Fama & Miller, The Theory of Finance 239-40 (1972).

likely to betray client confidentiality than those without such an affiliation. In fact, if the Litigation Section is correct about the bar's unique ability to maintain high ethical standards, we would expect "affiliated" investment bankers to behave more ethically than "independent" ones. And even if the Litigation Section is correct in believing that lawyers in diversified firms will not always be able to evaluate objectively the services of their ancillary businesses, that suggests at most that diversified law firms may not be optimal for some clients or for some matters, not that a total ban is appropriate. As discussed below, the adoption of certain proposed ethical rules should minimize the likelihood of consumer injury from diversified firms.

Indeed, the ethical problems that the ABA has identified can occur in "traditional" law firms as well as diversified firms. For example, issues of independence arise where a firm provides antitrust and tax advice to a client contemplating a merger, and could provide the corporate and securities work necessary to accomplish the transaction as well. The firm might be tempted to minimize the antitrust and tax risks of the proposed deal so as to induce the client to go forward with it, lest the firm lose the revenues from consummating the merger. Working Group Report, at 17. Similarly, because managers can find it more difficult to exercise quality control as an organization grows larger and more complex, the dangers that a firm will reveal client confidences, or allow its non-legal personnel to provide legal advice, may be greater in a 300-lawyer firm with no ancillary activities than in a 15-lawyer firm with a two-economist consulting business. In sum, law firm diversification is not very different from law firms having specialists in multiple areas of the law. The ABA's experience with multi-specialty law firms suggests that market forces, malpractice suits, and professional regulation generally can protect consumers from the problems that may arise when firms provide services in multiple areas of specialization, whether the specialized services are legal or ancillary.

The Standing Committee's proposal would impose on diversified law firms the same obligations to non-legal customers of their ancillary businesses as they currently have to their legal clients. Given that these requirements appear to protect legal clients from abuses, it seems likely that they are sufficient to address the ethical problems that law firm diversification may create. Indeed, the Rules may provide far more protection to customers of ancillary businesses of law firms than customers of non-affiliated businesses receive. Moreover, the Litigation Section -- which at one time expressed great concern about possible ethical problems -- now acknowledges that the Discussion Draft's "Proposed Rules for the most part

have benefitted from this practice. The Litigation Section cites no evidence to the contrary. Litigation Section Letter, at 9-16. Moreover, other professions, including the medical profession, increasingly practice in a wide variety of organizational structures without an apparent decline in professionalism. Thus, like the Standing Committee, we believe that possible harm from a decline in professionalism is too speculative and too unrelated to the provision of ancillary services to justify severe restrictions on such services, particularly in view of diversification's potential for providing immediate benefits to consumers. Discussion Draft, at 2-3. Proposed ethical rules narrowly tailored to prevent consumer harm should address the concerns raised adequately.

Second, even if professionalism concerns required some remedial action, the Section's proposal is at once too broad and too narrow a solution. It is too broad in that it restricts more activity than necessary to address the problems that the Section identifies. The Model Rules, particularly once amended along the lines that the Standing Committee proposes, may well forestall any "decline in professionalism" by extending the bar's relevant ethical standards to the provision of ancillary services. For example, an ancillary business would have to avoid conflicts of interest among its customers and clients of its parent law firm. As noted above, even a "traditional" firm must guard against the temptation to compromise its independent judgment in an effort to generate additional legal work. Similarly, the ABA can respond to concerns that the public will perceive the bar as less professional more directly, for example, through educational efforts aimed at managers of diversified law firms that will sensitize them to lawyers' professional obligations. Finally, the bar's ability to maintain its responsibility for self-regulation would appear to depend on the effectiveness of its disciplinary system at maintaining ethical standards, not on whether lawyers and firms elect to provide ancillary services.

The Litigation Section proposal is, on the other hand, too narrow in that it fails to address key components of the Section's own critique of diversification. For example, the Section's proposal would not address at all the possibility that a lawyer would compromise his or her independent professional judgment in connection with ancillary services that the firm provides incidental to legal services. Indeed, the proposal would bar firms from offering those services that present the least danger of compromising a firm's independent judgment: ancillary services unconnected with the firm's legal representation. Similarly, as the Litigation Section observes, the problems of sole practitioner diversification appear no less serious than those of firm diversification. The Section would nevertheless exempt sole practitioners because the problems "are

not likely to result in widespread criticism of the legal profession." Litigation Section Report, at 12.

Conclusion

We cannot offer a definitive evaluation of the ethical and professional challenges that law firm diversification poses, or of the effectiveness of the proposed solutions to them. As we have discussed, however, law firm diversification has the potential to provide significant benefits to consumers. The Litigation Section's approach would reduce these benefits substantially. The Standing Committee's approach, on the other hand, would appear to preserve the benefits of diversification while protecting consumers from the risk of harm.

We appreciate this opportunity to give you our views. Please feel free to contact us if you have any questions or if we can provide other assistance.

Sincerely,

for Kevin Arquit
Director