Fordham Law Review

Volume 65 | Issue 1 Article 12

1996

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Cover Page Footnote

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GAME THEORETIC AND CONTRACTARIAN PARADIGMS IN THE UNEASY RELATIONSHIP BETWEEN REGULATORS AND REGULATORY LAWYERS

*Richard W. Painter**

LEGAL scholars use several different theoretical paradigms to describe the regulatory process, including capture theory[1] and public choice theory.[2] Sometimes, but not often, the role of lawyers is included in the analysis.[3] This Article examines relationships between regulators, regulated firms, and lawyers from the vantage point of two other theoretical paradigms: game theory[4] and Coasian contractual

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1. Capture theory models the process by which regulated industries influence rule making and enforcement processes through their "capture" of regulators. *See* Paul J. Quirk, Industry Influence In Federal Regulatory Agencies (1981); Cass R. Sunstein, *Constitutionalism After the New Deal*, 101 Harv. L. Rev. 421 (1987); John Shepard Wiley, Jr., *A Capture Theory of Antitrust Federalism*, 99 Harv. L. Rev. 713 (1986).

2. Public choice theory explains statutes and regulations as the result of competing interest groups influencing the rule making process. *See* Daniel A. Farber & Philip P. Frickey, Law and Public Choice (1991); Daniel A. Farber & Philip P. Frickey, *The Jurisprudence of Public Choice*, 65 Tex. L. Rev. 873 (1987). An alternative "public purpose" theory of interpretation perceives rule making as a collective process that produces rational rules because checks and balances keep special interests from exerting excessive influence. *See* Henry M. Hart, Jr. & Albert M. Sacks, The Legal Process: Basic Problems in the Making and Application of Law (1994).

3. *See, e.g.*, Paul H. Rubin & Martin J. Bailey, *The Role of Lawyers in Changing the Law*, 23 J. Legal Stud. 807 (1994) (applying public choice model in which lawyers lobby for legal rules that increase their business just as other interest groups lobby legislators). Roberta Romano also explored the possibility of capture of regulators by lawyers, possibly even to the detriment of their clients:

> The targets of the SEC's [Securities and Exchange Commission] disclosure policy are primarily corporate issuers, and most corporations oppose the regulation. However, foes of the SEC, applying the insight of the capture theory, perceive the regulatory scheme to benefit security analysts, lawyers, and accountants, and neither investors nor firms. In this regard, the private institutions that bridge the information gap could be the principal beneficiaries and supporters of the disclosure laws.

Roberta Romano, *Metapolitics and Corporate Law Reform*, 36 Stan. L. Rev. 923, 1003 (1984).

4. Relevant literature on game theory includes: Robert M. Axelrod, The Emergence of Cooperation (1984); Douglas G. Baird et al., Game Theory and the Law (1994); Drew Fudenberg & Jean Tirole, Game Theory (1991); Diego Gambetta, Trust: Making and Breaking Cooperative Relations (1988); David M. Kreps, Corporate Culture and Economic Theory, Perspectives On Positive Political Economy (James Alt & Kenneth Shepsle, eds. 1990); David M. Kreps, Game Theory and Economic Modelling (1990) [hereinafter Kreps, Game Theory]; Michael Taylor, The Possibility of Co-

theory.[5] First, this Article looks at the work of regulatory lawyers as part of a series of "games" between regulators, regulated firms and lawyers, all of whom in this context will be referred to as "players." Next, this Article examines the interaction between these players through a contractarian lens and discusses the possibilities for "bargaining" between them. Neither of these two theoretical paradigms completely describes the relationship between lawyers and regulators, or all of the ways in which that relationship could evolve. Both are useful analytical tools, however, and offer valuable insights into conflicts between lawyers and regulators which seem to be occurring with increasing frequency. A central thesis of this Article is that because lawyers representing agencies and lawyers representing firms play the "regulatory game" with each other on a frequent basis and have opportunities to bargain, cooperative play between them can create substantial benefits for both. Such cooperative play between lawyers, if it evolves, is likely to foster cooperative play between agencies and regulated firms as well.

I. Who Should Regulate Lawyers and How?

A. *Choosing Regulators*

David Wilkins has brought to the forefront of scholarly debate the problem of determining who should regulate the legal profession. His article *Who Should Regulate Lawyers?*,[6] explores four paradigmatic approaches to enforcing professional norms: disciplinary controls,[7]

operation (1987); David M. Kreps & Robert Wilson, *Sequential Equilibria*, 50 Econometrica 863 (1982). For examples of applications of game theory to legal problems, see Ian Ayres, *The Possibility of Inefficient Corporate Contracts*, 60 U. Cin. L. Rev. 387 (1991); Martin Shubik, *Game Theory, Law, and the Concept of Competition*, 60 U. Cin. L. Rev. 285 (1991).

5. *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & Econ. 1 (1960). Chaos theory is another theoretical paradigm that has recently been juxtaposed to Coasian contractual theory and other concepts associated with law and economics. *See* James Gleick, Chaos: Making a New Science (1988). "Chaos here does not mean disorder, but that accurate predictions about where a system is headed are hard." Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 Harv. L. Rev. 641, 642 (1996). Although this Article does not use chaos theory, it does address the chaos that many lawyers perceive in a system where it is difficult to predict how regulators will respond to a given course of lawyer conduct. Hopefully, the game theory and Coasian contractual theory discussed here can assist lawyers and regulators in establishing some order and predictability in their relationship.

6. 105 Harv. L. Rev. 799 (1992).

7. "The reference point for this model is the current disciplinary system, in which independent agencies acting under the supervision of state supreme courts investigate and prosecute violations of the rules of professional conduct." *Id.* at 805. The basic structure resembles a criminal prosecution, the process is conducted *ex post* by officials with no prior involvement in the case, and the focus is on punishment and deterrence, not compensation. *Id.* at 805-06.

liability controls,[8] institutional controls,[9] and legislative controls.[10] This Article explores the third of these approaches, institutional controls, and gives specific attention to the role of state and federal agencies in regulating lawyers.

Wilkins mentions several advantages of institutional controls. Institutional enforcement authorities may observe lawyer misconduct directly[11] and have incentives to enforce lawyers' obligations to the legal system.[12] Furthermore, because enforcement officials and lawyers often are in a continuing relationship, sanctions can be both more immediate and more meaningful.[13] A danger exists, however, that enforcement officials will go overboard and "overdeter" conduct that is generally perceived by the bar to be acceptable.[14]

Many of Wilkins's generalizations about institutional controls are pertinent to regulation of lawyers by agencies whose primary focus is regulation of the lawyers' clients. Regulators are uniquely positioned to discover lawyer misconduct, particularly in more complex practice areas such as banking and securities regulation. Regulators have an incentive to initiate enforcement proceedings against recalcitrant lawyers. Regulators also can overreact.[15] Thus, it is important to examine how regulatory agencies establish and enforce professional conduct norms, and how lawyers respond, before deciding how much authority these agencies should have in regulating the legal profession. Game theoretic paradigms explain some of this interaction between agencies and lawyers and are useful tools for predicting how their relationship might evolve if agencies were given an enhanced role in regulating lawyers.

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8. This model is based on litigation brought by injured clients and third parties against lawyers for "breaching ethical duties." *Id.* at 807. "Like the disciplinary model, liability controls operate on the basis of ex post complaints by injured parties. A victorious claimant, however, is entitled to full compensatory and even punitive damages." *Id.*

9. Institutional controls "share a common goal: to locate enforcement authority inside the institutions in which lawyers work. As a result, the structure and operation of any particular system will be primarily a function of the institution within which it is situated." *Id.* at 808. Examples of such institutions include the courts, the SEC, the Office of Thrift Supervision ("OTS"), and the Internal Revenue Services ("IRS"). *Id.*

10. Although not yet implemented, this model contemplates establishing a new administrative agency to regulate lawyers. Such an agency "might be patterned after the agencies that currently regulate doctors in many states." *Id.* at 808.

11. *Id.*

12. *Id.* at 837.

13. *See id.* at 808, 836-37.

14. *Id.* at 837.

15. Many lawyers believe that the OTS overreacted to alleged lawyer misconduct in the savings and loan crisis of the late 1980s. *See infra* note 139. The SEC's proceedings against lawyers, alleged to have caused client noncompliance with the disclosure requirements of the securities laws, have also been sharply criticized. *See infra* note 139.

B. *Choosing Rules and Remedies*

David Wilkins has challenged the assumption that all lawyers should be bound by the same rules and has emphasized the importance of context in formulating rules of professional conduct.[16] Judge Sporkin has also suggested that rules of professional conduct should differ for different practice areas.[17] Some rules of professional conduct, for example, may be appropriate for criminal litigation[18] but not for transactional lawyering.

One advantage of using regulators to regulate lawyers is that specialized agencies are familiar with the context in which lawyer conduct rules apply. Regulatory agencies are thus more likely to accommodate differences between practice areas than disciplinary committees or other institutions charged with regulating lawyers in many practice areas. Also, regulatory agencies usually have more flexibility in crafting remedies than state disciplinary authorities, which often cannot impose substantial monetary sanctions, bar lawyers from certain fields of practice, or impose structural remedies on law firms.[19]

Furthermore, as discussed later in this Article, contractarian theory underscores unique opportunities that regulatory agencies have to influence lawyer conduct *ex ante* (before alleged misconduct occurs) rather than merely discipline lawyers *ex post*.[20] Agencies can work with lawyers in a specific practice area to fashion mutually agreeable rules of professional conduct that resemble a "contract" between the agency and lawyers rather than an immutable set of standards imposed from above. One advantage of this contractual approach is that

16. David B. Wilkins, *Making Context Count: Regulating Lawyers After Kaye, Scholer*, 66 S. Cal. L. Rev. 1145, 1151-60 (1993) [hereinafter Wilkins, *Regulating Lawyers After Kaye, Scholer*]; *see also* David B. Wilkins, *Legal Realism for Lawyers*, 104 Harv. L. Rev. 468, 515-24 (1990) (stating that focus on context must replace the traditional model's commitment to universal ethical rules) [hereinafter Wilkins, *Legal Realism for Lawyers*].

17. *See* Stanley Sporkin, *The Need for Separate Codes of Professional Conduct for the Various Specialties*, 7 Geo. J. Legal Ethics 149, 149 (1993).

18. *See, e.g.*, Geoffrey C. Hazard, Jr., Ethics In The Practice Of Law 150 (1978) ("The central ideas in the legal profession's code of ethics originally arose out of criminal cases, particularly the defense of criminal cases.").

19. Ted Schneyer, *From Self-Regulation to Bar Corporatism: What the S&L Crisis Means for the Regulation of Lawyers*, 35 S. Tex. L. Rev. 639, 645-50 (1994) [hereinafter Schneyer, *Bar Corporatism*]; *see also* Ted Schneyer, *Professional Discipline For Law Firms?*, 77 Cornell L. Rev. 1, 13-14 (1991) (suggesting that disciplinary authorities have not had jurisdiction over law firms in the past). By contrast, the SEC can suspend an entire law firm under Rule 2(e). *See* Securities Act Release No. 5,147 [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,064 (May 10, 1971), *cited and discussed in*, Robert W. Emerson, *Rule 2(e) Revisited: SEC Disciplining of Attorneys Since* In re Carter, 29 Am. Bus. L. J. 155, 157 n.4 (1991).

20. Lawyer discipline is generally a reactive process, although lawyer supervision by regulators can be prospective. Schneyer, *Bar Corporatism*, *supra* note 19, at 643-45, 648-50. "The reactive nature of lawyer discipline may help to explain why state disciplinary agencies were in no position before the S&L failures to halt any law-firm practices that jeopardized the soundness of thrift clients." *Id.* at 645.

both default rules, rules that parties may contract around, and tailored rules, rules agreed to by lawyers and agencies to substitute for default rules, are likely to be clear and easy to follow. Immutable rules, by contrast, can be remarkably unclear if they emerge from uneasy compromise among different constituencies which cannot agree on what a lawyer's responsibilities are.

II. THE GAME THEORETIC PARADIGM

Significant scholarship exists which relates game theory to the work of the regulatory state,[21] as well as to lawyers' roles in negotiations and litigation strategy.[22] There is, however, little discussion of "games" between regulators, regulated firms *and lawyers*. This Article expands upon existing paradigms of games between regulators and regulated industry by introducing new "players," the lawyers who represent both regulatory agencies and regulated firms.

A. *Agency/Firm Games*

Ian Ayres's and John Braithwaite's book, *Responsive Regulation*, is a comprehensive application of a game theoretic model to interaction between regulatory agencies and regulated firms. Nonetheless, their discussion does not emphasize the role of regulatory lawyers. After discussing the game theoretic model used by Ayres and Braithwaite, this Article will speculate as to how this model might look once lawyers representing both regulators and regulated firms are injected into the game.

Ayres and Braithwaite use a game that was first modeled by John Scholz in his work on interaction between regulatory agencies and regulated firms.[23] Scholz's game in turn is modeled on the classic "prisoner's dilemma" game.[24] While Ayres and Braithwaite use

21. *See* Ian Ayres & John Braithwaite, Responsive Regulation: Transcending the Deregulation Debate (1992); John T. Scholz, *Cooperation, Deterrence, and the Ecology of Regulatory Enforcement*, 18 Law & Soc'y Rev. 179 (1984); John T. Scholz, *Voluntary Compliance and Regulatory Policy*, 6 Law & Pol'y 385 (1984) [hereinafter Scholz, *Voluntary Compliance*].

22. *See* Ronald J. Gilson & Robert H. Mnookin, *Disputing Through Agents: Cooperation and Conflict Between Lawyers in Litigation*, 94 Colum. L. Rev. 509 (1994). Gilson and Mnookin use "the prisoner's dilemma as a heuristic to . . . describe a litigation game in which each disputant faces a single choice: she can either cooperate by volunteering all relevant information to the other side or defect by using the discovery process in an adversarial manner to hide unfavorable information." *Id.* at 512. Gilson and Mnookin first examine this game "in an abstract world in which there are no lawyers," and then "explore the role that lawyers might play in overcoming the prisoner's dilemma." *Id.* Their theoretical framework is followed by discussion of an informal survey of San Francisco matrimonial lawyers that "strongly suggests that the relationship between lawyers known to each other to have cooperative, problem-solving orientations facilitates dispute resolution." *Id.* at 546.

23. Scholz, *Voluntary Compliance*, *supra* note 21, at 385.

24. The basic prisoner's dilemma problem involves the following hypothetical: Two men commit armed robbery and are arrested on weapons charges. Both suspects

Scholz's model of enforcement of environmental laws, this Article uses a similar model of enforcement of depository institution regulations. The payoffs for the agency are easier to quantify in the depository institution model, increased safety and soundness of a regulated institution brings *expected* savings to the insurance fund,[25] but the modelling of strategies for the firm and agency is similar in both models.

In this game, modeled in Figure 1, regulated firms choose between two strategies, "compliance" with regulators or "evasion." Firms that choose to comply conform their conduct to the letter of the law as well as the underlying objectives of regulation.[26] Firms that choose to

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are held in separate rooms where they cannot talk to each other. The district attorney approaches one of the suspects and says, "We know that you robbed the bank. If you testify against your friend we will let you go free and your friend will get 15 years; if you don't we have enough to get you on a weapons charge and you will get one year in jail." The prisoner of course asks, "What's the catch?" The district attorney replies, "The catch is that we are offering the same deal to your friend and if both of you turn in the other, both of you will get 10 years for armed robbery." This is the essence of the basic prisoner's dilemma problem. Each person has to decide how to play based only on how she thinks the other person will play. This game is usually modeled as follows:

		Prisoner B	
		Silence	Talk
Prisoner A	Silence	1,1	15,0
	Talk	0,15	10,10

Example 1.
The first number refers to prisoner A's payoff. The second number refers to prisoner B's payoff. The game starts in the upper left hand quadrant. What will normally happen when neither party has colluded beforehand is that both prisoners will decide to talk and they will both end up getting 10 years.

Although the prisoner's dilemma game is a useful paradigm for Scholz's analysis of interaction between agencies and firms and is used in the Ayres and Braithwaite analysis, it is important to recognize that other games could provide interesting insights into interaction between firms and regulators:

> [O]ne always wants to examine the strategic elements in a given situation and avoid being drawn too quickly to a well-known paradigm such as the prisoner's dilemma. Such paradigms can become Procrustean beds, and, by rushing to one or another too quickly, one may miss important parts of a problem.

Baird, *supra* note 4, at 45. Nonetheless, the analysis in this Article will follow Ayres and Braithwaite in using the prisoner's dilemma game, while recognizing that other paradigms may offer equally important insights and should perhaps be the subject of further study.

25. A financial institution that fails imposes substantial expense on the insurance fund. For a single institution, the payoff to the insurance fund from increased safety and soundness can be estimated *ex ante* (if certain measures are implemented the chance of failure drops from x% to y%; the cost of failure is Z; the expected savings to the fund is (x-y)% multiplied by Z).

26. Ayres & Braithwaite, *supra* note 21, at 60. Former OTS Chief Counsel Harris Weinstein has promoted the concept of practicing the "whole law," or determining whether transactions that may be legal when viewed in isolation together threaten an institution's safety or soundness. The attorney for a depository institution, Weinstein

evade comply only with the letter of the law if forced to and ignore the objectives of regulation. In like manner, regulatory agencies choose between "cooperative" and "deterrence" enforcement strategies. A cooperative enforcement strategy involves less regulatory scrutiny and monitoring, and the agency tolerates some technical violations of regulations.[27] A deterrence enforcement strategy, on the other hand, involves vigorous regulatory scrutiny and zero tolerance for regulatory violations.[28]

The firm gets the highest "temptation" payoff, only a $1 million cost of compliance, labeled "opportunism" in Figure 1, if (i) it chooses an evasion strategy and (ii) the agency chooses a cooperation strategy and gets stuck with the lowest "sucker" payoff, only a $50 million expected savings to the insurance fund from the firm's compliance. Conversely, the agency gets the "temptation" payoff, labeled "harassment" in Figure 1, of being able to extract the highest level of regulatory compliance[29] if (i) it chooses a deterrence strategy and (ii) the firm chooses a compliance strategy, which leaves the firm stuck with the lowest "sucker" payoff. Between these two extremes are the "reward" payoff, labeled "voluntary compliance" in Figure 1, that both players receive if the agency chooses a cooperative strategy while the firm chooses a compliance strategy, and the lower "punishment" payoff (labeled "legalistic battles" in Figure 1) that both players receive if the agency chooses a deterrence strategy while the firm chooses an evasion strategy. For each player, the payoffs are such that temptation

urges, must measure "his or her true obligations by reference to regulatory requirements, concepts of safety and soundness, and fiduciary responsibilities." *Advice on How to Exploit Loopholes May Be Unethical, OTS' Weinstein Says*, 56 Banking Rep. (BNA) 616 (April 1, 1991).

> One of the most powerful implications of the 'whole law' theory is that banking lawyers may have to instruct officers and directors of federally insured depository institutions to avoid 'unsafe and unsound' banking practices in fulfillment of an asserted fiduciary duty to act in the interests of depositors and the federal government.

Note, *Developments in the Law—Lawyers' Responsibilities and Lawyers' Responses*, 107 Harv. L. Rev. 1547, 1613 (1994), *comparing*, Jonathon R. Macey & Geoffrey P. Miller, *Kaye, Scholer, FIRREA, and the Desirability of Early Closure: A View of the Kaye, Scholer Case from the Perspective of Bank Regulatory Policy*, 66 S. Cal. L. Rev. 1115, 1129-31 (1993) (arguing that allegations against Kaye, Scholer based on this theory were "nothing short of incredible"), *with*, Lawrence G. Baxter, *Fiduciary Issues in Federal Banking Regulation*, 56 Law & Contemp. Probs. 7, 8 (1993) (arguing that this fiduciary duty of lawyers can be inferred from the banking statutes).

27. Ayres & Braithwaite, *supra* note 21, at 60; Scholz, *Voluntary Compliance*, *supra* note 21, at 385.

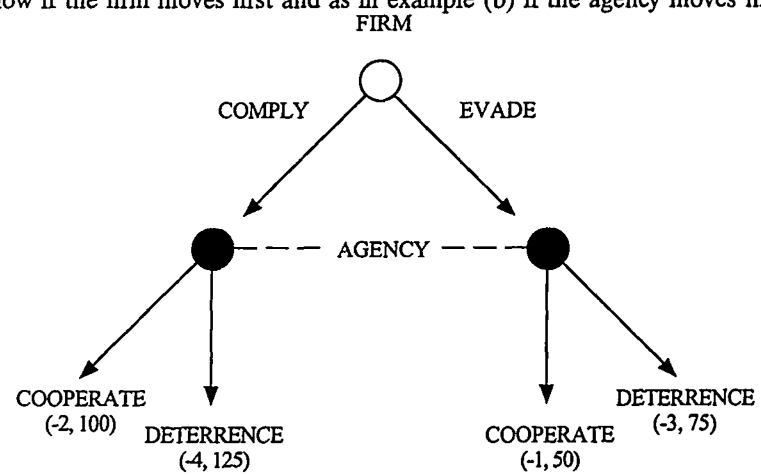
28. Ayres & Braithwaite, *supra* note 21, at 60-63.

29. Overcompliance with depository institution safety and soundness regulations can still result in increased savings to the insurance fund. An institution that avoids even the level of high-risk loans allowed under applicable regulation is perhaps even less likely to fail than an institution that is complying with the regulation, but doing nothing more. Indeed, regulators may bully some institutions into excessively conservative lending practices, thereby transferring wealth from the institution's shareholders to the insurance fund, in order to make up for regulatory laxity elsewhere.

> reward > punishment > sucker. In a strategic form model[30] of this game, the firm's initial compliance options are arranged as rows and the agency's enforcement options as columns, as shown in Figure 1. The payoffs that each player receives are shown in the boxes corresponding to the strategies the player has chosen. For example, the box in the left hand column and top row shows that if the firm chooses to comply and the agency chooses to cooperate, the firm has a payoff r = -$2 million, the cost of compliance, and the agency has a payoff of R = $100 million, the amount of expected savings to the insurance fund.

30. The strategic form model is comprised of "(1) a list of participants, or *players*, (2) for each player, a list of *strategies*, and (3) for each array of strategies, one for each player, a list of *payoffs* that the players receive." Kreps, Game Theory, *supra* note 4, at 10. A two player game is represented as a two dimensional table, with the players' strategies arranged along either the top or the left side of the table. A three player game is represented as a series of two dimensional tables, with each of the third player's strategies corresponding to one of the tables. "Think of the three boxes as being stacked one atop another like a multi-story parking-lot, and then [the third player] chooses the level." *Id.* at 12.

A "second type of model of a game that is used in noncooperative game theory is an extensive form game," *id.* at 13, which, unlike the strategic form game, shows the order in which players choose the actions they will take. The extensive form game is depicted with dots, called "nodes," each representing a position in the game at which one of the players must choose an action. The first position is depicted by an open dot and the remaining dots are filled in. A letter next to each node indicates which player must choose an action at that position in the game. Each choice that is feasible for the choosing player is represented by an arrow, and each arrow points either to another node, representing a new position in the game, or to an endpoint of the game represented by a vector of numbers showing the payoffs of the players in order (i.e., player A, then B, then C, or player 1, then 2, then 3). *Id.* at 13-14. The game shown in strategic form in Figure 1 would be depicted in extensive form as in example (a) below if the firm moves first and as in example (b) if the agency moves first:

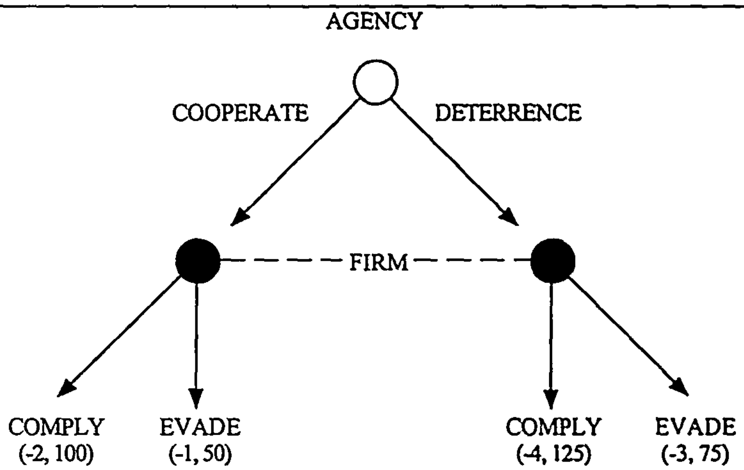


Example (2)(a)

		AGENCY'S ENFORCEMENT OPTIONS	
		COOPERATE (goal oriented)	DETERRENCE (rule-oriented)
FIRM'S INITIAL COMPLIANCE OPTIONS	COMPLY	R = \$100 million VOLUNTARY COMPLIANCE r = -\$2 million	T = \$125 million HARASSMENT s = -\$4 million
	EVADE	S = \$50 million OPPORTUNISM t = -\$1 million	P = \$75 million LEGALISTIC BATTLES t = -\$3 million

FIGURE 1.[31]

In a single period game, both players would most likely choose the defection strategy—deterrence for the agency; evasion for the firm—knowing that such a strategy will maximize a player's payoff in that round regardless of how the other player acts. Thus, unless there is more than one round and a player can influence what the other player will do in future rounds, no incentive to cooperate exists. Joint defec-



Example (2)(b)

31. *See* Scholz, *Voluntary Compliance, supra,* note 21, at 389; Ayres & Braithwaite, *supra* note 21, at 61. In game theory terminology, the defection strategy is said to "dominate" the others. *See* Ayres & Braithwaite at 26-29 (discussing dominance arguments as a solution technique in non-cooperative game theory). Player A will not choose strategy *x* if, regardless of the strategy Player B chooses, strategy *y* gives Player A a better payoff. In a single round game, row 2 in Figure 1 thus dominates row 1 for the Firm and column 2 dominates column 1 for the Agency.

tion (row 2, column 2) thus would be the only Nash equilibrium[32] in a single round game.

In a multi-round game, however, a player may estimate the expected present value of the player's accumulated payoffs from present plus all future rounds. For example, the present value of all the firm's payoffs V_f, given firm strategy *f* and agency strategy *a* would be:

Equation (1):

$$V_f(f,a) = V_{ft}(f_t,a_t) + \Delta V_{ft+1}(f_{t+1},a_{t+1}) + \Delta^2 V_{ft+2}(f_{t+2},a_{t+2}) + \ldots$$ [33]

The present value of all the agency's payoffs V_a, given firm strategy *f* and agency strategy *a* would be:

Equation (2):

$$V_a\ (f,a) = V_{at}(f_t,a_t) + \Delta V_{at+1}(f_{t+1},a_{t+1}) + \Delta^2 V_{at+2}(f_{t+2},a_{t+2}) + \ldots$$

if:

f_t = the firm's strategy in the *t*th period;
a_t = the agency's strategy in the *t*th period;
where 1_t = cooperate and 2_t = defect;
$V_{ft}(f_t,a_t)$ = the firm's payoff for the *t*th period; and
$V_{at}(f_t,a_t)$ = the agency's payoff for the *t*th period.[34]

The discount parameter Δ reflects the diminished value of a payoff that is deferred for one round[35] and every future payoff is multiplied by this discount factor one time for each round that particular payoff is deferred. For example, a payoff three rounds in the future is multiplied by Δ^3.

The game theoretic model defined by Scholz and used by Ayres and Braithwaite has two easily identifiable Nash equilibria for multi-period games between regulators and regulated firms:

(i) Joint cooperation

Regulators cooperate with firms and firms choose voluntary compliance.[36] This equilibrium is likely if conditions are ripe for mutual trust between regulators and regulated firms, regulators and regulated firms are repeat players who deal with each other on multiple occasions, and if noncooperative conduct is easy to detect.

(ii) Joint defection

32. "A Nash equilibrium is an array of strategies, one for each player, such that no player has an incentive (in terms of improving his own payoff) to deviate from his part of the strategy array." Kreps, Game Theory, *supra* note 4, at 28. For discussion of game-theory equilibria, see David M. Kreps & Robert Wilson, *Sequential Equilibria*, 50 Econometrica 863 (1982).

33. Ayres & Braithwaite, *supra* note 21, at 62.

34. *Id.*

35. The discount parameter is inversely related to the discount rate *r*, often thought of as the prevailing rate of interest, so that $\Delta = 1/(1+r)$. *Id.* at 62.

36. A variety of strategies could be deployed to reach this equilibrium. Ayres and Braithwaite focus on a tit-for-tat ("TFT") strategy, although a variety of other cooperative strategies could be deployed as well. *See infra* note 49 and accompanying text.

> Regulators seek to deter firms and firms choose evasive strategies. This equilibrium is particularly likely if regulators and regulated firms do not trust one another, are not repeat players, or can engage in noncooperative conduct that is difficult to detect.

The joint cooperation equilibrium is the Pareto optimal[37] equilibrium because the agency can spend less on monitoring the firm and enforcing its rules, and the firm can spend less on compliance and litigation than if play devolved into a joint defection equilibrium.[38]

Firm/agency games, however, can be far more complex than this single version of the Scholz model might imply, as changes in payoffs[39] can create different Nash equilibria. For example, given the right set of payoffs, the following two strategies might constitute a Nash equilibrium:

> (i) Agency alternates between cooperative and non-cooperative actions, as long as Firm plays cooperatively at all times (and Firm does not deviate from this pattern); Agency plays non-cooperatively forever in the event of any deviation.
> (ii) Firm plays cooperatively at all times, as long as Agency alternates between cooperation and non-cooperation (and Firm does not deviate from cooperation); Firm plays non-cooperatively forever following any deviation from this strategy by the Agency.

Will Firm tolerate this result?[40] The answer depends on the payoffs. If the payoffs are such that Firm will do better playing this strategy than if it deviates, these strategies will constitute a Nash equilibrium.

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37. "When the economy's resources and output are allocated in such a way that no reallocation can make anyone better off without making at least one other person worse off then a Pareto optimum is said to exist." The MIT Dictionary of Modern Economics 320 (David W. Pearce ed., 3d ed. 1986). The joint cooperation equilibrium is not Kaldor-Hicks efficient, however, if regulators can somehow force play into a harassment equilibrium, which in Figure 1 maximizes total social wealth ($121 million, or $125 million savings to the insurance fund less $4 million in compliance costs).

> Kaldor-Hicks holds a move efficient if the winners gain more than the losers lose, such that aggregate gain is possible if the losers are appropriately compensated. This formulation is often used as a theoretic justification for government regulation, which invariably harms someone. The difficulty with Kaldor-Hicks is that compensation from winner to loser is not required.

Maxwell L. Stearns, *Standing Back from the Forest: Justiciability and Social Choice*, 83 Cal. L. Rev. 1309, 1372 n.197 (1995) (citation omitted).

38. Ayres & Braithwaite, *supra* note 21, at 60.

39. *See id.* at 61.

40. These two strategies are discussed in Kreps, Game Theory, *supra* note 4, at 98-99. "[I]f the game is asymmetric, then asymmetric equilibria do not seem so unreasonable." *Id.* For example, the following game might very well lead to an asymmetric equilibrium:

		Firm: cooperate	Firm: non-cooperate
Agency	cooperate	5,6	−1,7
	non-cooperate	6,−1	2,0

Example 3

A different set of payoffs might allow the agency to play a non-cooperative strategy one third of the time so long as the Firm cooperates all of the time; yet another might allow the Firm to play non-cooperatively three times out of four and cooperate one fourth of the time so long as the Agency always plays cooperatively. The payoffs in the boxes of the strategic form game determine whether a set of strategies will be a Nash equilibrium. Each firm/agency game is different.

Can we predict how a firm/agency game will be played? Yes, if there is a self-evident or obvious way to play.[41] The Pareto optimal Nash equilibrium, however, is not necessarily the only Nash equilibrium and it is not necessarily a self-evident way to play. Indeed, formal game theory may tell us very little about whether there is a self-evident way to play, and if there is, what it might be. As David Kreps points out:

> [I]n some games with multiple equilibria, players still "know" what to do. This knowledge comes from both directly relevant past experience and a sense of how individuals act generally. And formal mathematical game theory has said little or nothing about where these expectations come from, how and why they persist, or when and why we might expect them to arise.[42]

Absent an obvious way to play, firms and agencies might settle into any one of several Nash equilibria, or possibly even into a disequilibrium, such as agency cooperate/firm defect or agency defect/firm cooperate. The players might even elect to play randomized strategies, with the agency or the firm randomly selecting periods in which to defect or cooperate.[43] The next part will explore whether lawyers

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See id. at 98, Fig. 5.2(b). If the agency defects, the firm here is only slightly (one point) worse off cooperating than not cooperating. Because the firm is much (6 points) better off with mutual cooperation than mutual defection, the firm is likely to respond to a single round of agency defection by continuing to cooperate and hoping for the best.

41. "If the game in question has or will come to have an evident way to play, then a necessary condition for that evident way to play is that it is a Nash equilibrium." Kreps, Game Theory, *supra* note 4, at 134. "[W]hen a particular game has no evident way to play and we do not believe that one will be developed (say, via negotiation), then there is no reason to study the set of equilibria." *Id.* at 135.

42. *Id.* at 101 (emphasis omitted). As Kreps points out, the best discussion of these expectations remains the original treatment by Thomas Schelling, The Strategy of Conflict (1960). David Kreps notes that "little to no progress has been made in exploring Schelling's insights." Kreps, Game Theory, *supra* note 4, at 101.

43. Poker is perhaps the best example of randomized strategies as illustrated below:

> If you hold a bad hand, you will sometimes bet heavily on it and sometimes not, choosing (in each instance) randomly between bluffing (betting) and not. The idea is that you don't want your betting behavior to signal to your opponents what cards you hold; you randomize between bluffing and not so that when you bet heavily, your opponent is confused as to whether you hold a good hand or not. Moreover, in an equilibrium you would choose between bluffing or not with a bad hand just enough so that your opponent is indifferent between calling your bluff or giving in to it; if your opponent always calls

help agencies and firms find and utilize a self-evident way to play that brings them closer to the Pareto optimal equilibrium.

Nonetheless, a set of strategies exists that gives Pareto optimal payoffs, although it is difficult to predict when players will choose to play that way. Robert Axelrod's research suggests that for a large enough discount parameter Δ, a tit-for-tat (TFT) strategy "can be an equilibrium strategy for both players in a repeated period prisoner's dilemma" and that, if played by both players, this strategy "engenders the Pareto optimal jointly cooperative payoffs."[44] In a TFT strategy,

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> your bluff, then you would do better never to bluff, while if your opponent always folds when you bid heavily, you would do better to bluff with higher frequency, to win more hands with poor cards.

Id. at 103 n.6.

Interaction between a firm and a regulatory agency can be very much like a poker game, and I have previously compared the role of the lawyer to that of a confidant advising each of the players on how to play. Richard W. Painter, *The Moral Interdependence of Corporate Lawyers and Their Clients*, 67 S. Cal. L. Rev. 507, 541-42 (1994). In this poker game:

> [E]ach player hires a confidant who walks around the table peering into other players' hands. Assume also that the confidant cannot tell the player directly what cards other players have because the player's vocabulary does not include the words heart, spade, club, or diamond, or words to describe whole numbers. Only the most general communication such as "high," "low," and "face card" is possible. Finally, assume that none of the players can see their own hand, which lies face down on the table, and that only the confidant can look at it and explain the hand's strengths and weaknesses to the player as best as possible in language that the player can understand. Even if the players understand the rules of the game well enough to frame their own objectives, they are most likely to win if they communicate their objectives to their confidant and allow the confidant to decide which cards to play.

Id.

44. Ayres & Braithwaite, *supra* note 21, at 62. Axelrod structured a computer tournament in which he invited professional game theorists to submit strategies that would then be paired off against one another in prisoner's dilemma games of two hundred moves each. Robert Axelrod, The Evolution of Cooperation 30, app. A: Tournament Results at 192-205 (1984). TFT won the tournament by achieving the highest average score when played against the other strategies. *Id.* at 31. Gilson and Mnookin draw on Axelrod's work to infer that "there may be circumstances under which the parties can escape the prisoner's dilemma if there are significantly high prospects that they will have a large number of future dealings with each other and that they care enough about the outcomes of those future dealings." Gilson & Mnookin, *supra* note 22, at 521.

Although Axelrod's computer simulations show TFT to be the optimal strategy, his observations of cooperation in real world settings reveal that a variety of strategies are employed to achieve Pareto optimal jointly cooperative payoffs. One of the most intriguing settings that Axelrod discusses is the "live and let live" system that evolved during the trench warfare in World War I in which soldiers often restrained from firing on the other side so long as their restraint was reciprocated. Axelrod, *supra* note 4, at 21. When the British Battalions were rotated, the soldiers in the old battalion would inform the incoming battalion of the optimal strategy for dealing with the Germans: "'Mr. Bosche ain't a bad fellow. you leave 'im alone; 'e'll leave you alone.'" *Id.* at 81. "When defection actually occurred, [however], the retaliation was often more than would be called for by TIT FOR TAT. Two-for-one or three-for-one "a prisoner's dilemma player cooperates until the opponent defects and responds by defecting until the opponent cooperates."[45] Assuming the discount factor is high enough, a player has an incentive to cooperate because a temptation payoff today cannot make up for lower punishment payoffs tomorrow.[46]

Other recent research, however, indicates that a more forgiving strategy than TFT may be advantageous in many circumstances, particularly if actors are "slow to cooperate or easy to offend" or if "noise" occurs in the form of "mistakes, accidents, and misperceptions."[47] Indeed, a TFT strategy may require a detailed record keeping or "accounting" system and other monitoring costs which more forgiving strategies may avoid.[48] Such strategies include Tit For 2 Tats (continue to cooperate until the other player defects twice in a row) and Tit For 2 Tats Maximum (match the most generous of the other player's two previous moves).[49]

Thus, although Scholz demonstrates the *possibility* of efficient firm/agency cooperation, his model does not predict what strategies firms and agencies actually will choose to play if they seek out a cooperative strategy. Furthermore, empirical observation would probably reveal a great many cases in which joint cooperation is not the equilibrium reached in firm/agency games. This may result because either firms or agencies are not solely interested in maximizing payoffs, or even if they are, TFT or another cooperative strategy simply is not the self-evident way to play.[50] Some factors actually steer regulators and regulated firms *away* from strategies that engender the Pareto optimal

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was a common response to an act that went beyond what was considered acceptable." *Id.* at 80.

In like manner, the reaction of banking regulators to lawyers who defect from cooperative play has sometimes been overreaction or even the type of massive retaliation characteristic of a game defined by an inherently hostile environment. *See infra* note 188 and accompanying text; Wilkins, *supra* note 6, at 837 (discussing the risk of overdeterrence through institutional controls).

45. Ayres & Braithwaite, *supra* note 21, at 62.

46. *Id.* Axelrod specifically discusses Scholz's model of the iterated prisoner's dilemma game between firms and regulatory agencies. "The agency can adopt a strategy such as TIT FOR TAT which would give the company an incentive to comply voluntarily and thereby avoid the retaliation represented by the coercive enforcement policy." Axelrod, *supra* note 44, at 156.

47. Peter Kollock, *"An Eye for an Eye Leaves Everyone Blind": Cooperation and Accounting Systems*, 58 Am. Soc. Rev. 768, 769 (1993).

48. *See id.* at 770. Circumstances exist, however, in which formulating contracts among agencies, firms, and their lawyers can be advantageous. *See infra* notes 107-11 and accompanying text.

49. Kollock, *supra* note 47, at 774.

50. Less forgiving strategies than TFT predominated in the cooperative behavior of opposing forces in World War I. *See* Axelrod, *supra* note 44 and accompanying text. In other scenarios, there may not be any cooperative strategy that is self-evident to the players.

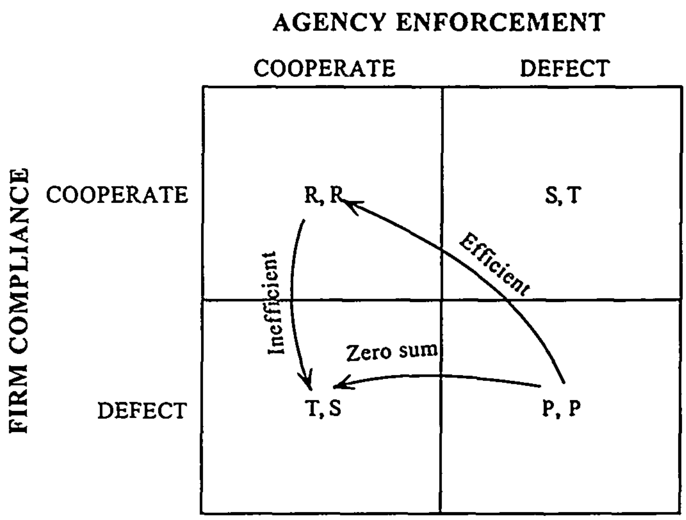
joint cooperation equilibrium.[51] Ayres and Braithwaite discuss two such factors: (i) capture of regulators by regulated industry; and, (ii) low discount parameters that cause either regulators or regulated industry to assign a low value to future payoffs from cooperation relative to present payoffs from opportunistic defection.

The first of these factors, regulatory capture,[52] is discussed extensively by Ayres and Braithwaite, who identify three different types of capture: "1. [i]nefficient capture: where joint cooperation shifts to a firm defect:agency cooperate equilibrium; 2. [z]ero-sum capture: where joint defection shifts to a firm defect:agency cooperate equilibrium; [and] 3. [e]fficient capture: where joint defection shifts to a joint cooperation equilibrium."[53] Inefficient capture and zero-sum capture both increase the agency's sucker payoff above its punishment

51. I discuss two factors that shape equilibria, cultural norms and focal points, more extensively in my discussion of firm lawyer-agency lawyer games. *See infra* notes 82-97 and accompanying text.

52. *See supra* note 1.

53. Ayres and Braithwaite model the different types of capture in the following diagram:



[where first letter represent firm's payoff
second letter represent agency's payoff]

R = reward payoff
S = sucker payoff
T = temptation payoff
P = punishment payoff
T>R>P>S 2R>S+T

Example 4
Ayres & Braithwaite, *supra* note 21, at 69.

payoff, so the "agency will not retaliate if the firm defects."[54] Inefficient capture results when, without capture, the agency and firm both would have cooperated; it is wealth reducing because the agency and the firm together receive lower payoffs than they would through joint cooperation as the gain to the firm from a "temptation" payoff does not make up for the loss to the agency from a "sucker" payoff. Zero-sum capture results when, without capture, the agency and firm both would have defected, but with capture the agency cooperates while the firm defects. Zero-sum capture has "ambiguous welfare consequences," but "unfair distributive effects" because it rewards firm defection.[55] Efficient capture, on the other hand, reduces the agency's temptation payoff and encourages cooperation that the agency might otherwise forego in favor of defection. Efficient capture is wealth increasing because it induces the agency to pursue a cooperative strategy.[56]

Ayres and Braithwaite mention another factor steering regulators and regulated firms toward a joint defection equilibrium, but they do not emphasize this second factor in their analysis as much as regulatory capture; regulators and regulated industry alike may place a low value on future payoffs from cooperation relative to present payoffs from opportunistic defection. This disparity between the value of a present versus future payoff is usually expressed as in Equation 1[57] by multiplying the expected payoff in the *n*th period of play by a discount parameter Δ—inversely related to the discount rate—raised to the *n*th power. Even though this discounting equation is modeled on the time value of money, factors other than the time value of money, such as personal concerns of firm managers or political concerns of agency administrators, can change discount parameters. Furthermore, players' perceptions of discount parameters, not actual discount parameters, determine play in most games, and play can be steered away from cooperation toward joint defection when decisionmakers who choose strategies for agencies or for firms think in terms of short time horizons.

For example, a cynic might suggest that political superiors supervising regulatory agencies see the discount parameter Δ in period n as being close to zero if period n is beyond the date of the next election.

54. *Id.* at 63. The capture formula used by Ayres and Braithwaite for a single-period payoff is:

$$V'_{at}(f_t,a_t) = \alpha\ V_{ft}(f_t,a_t) + (1 - \alpha)\ V_{at}(f_f,a_t)$$

where $1 \leq \alpha \leq 0$. The variable α is a measurement of capture, and the other parameters are those defined in Equation 1 *supra*. "When $\alpha = 0$, the agency's payoff is simply the same as in the original enforcement game (in which the agency was implicitly trying to maximize social welfare). When $\alpha = 1$, however, capture is complete in that the agency payoff is identical to the regulated firm's payoff. For intermediate values of α, the agency's payoff is a weighted average of the public and private concerns." *Id.*

55. *Id.* at 65, 69.

56. *Id.*

57. *See supra* note 33 and accompanying text.

At a minimum, agency administrators and their political superiors may view a one-shot temptation payoff from harassing a regulated firm at the right time as being far more valuable than a greater reward payoff from cooperation spread out over a longer period of time. If the political superiors want a temptation payoff now, and if there is little or no efficient capture to discourage agency defection,[58] agency administrators may be pressured from above to pursue a harassment strategy regardless of future consequences. Regulated firms, anticipating that regulators will defect to maximize short term payoffs, will likely defect as well. For example, an administration that has promised to crack down on depository institutions may assign a low discount parameter to future payoffs from joint cooperation and instead favor a one-shot harassment payoff in an election year. Depository institutions, knowing the administration's promises to the electorate and anticipating when regulators will implement their defection strategy, will avoid the sucker payoff by defecting as well.[59]

On the industry side, corporate managers may also think in terms of shorter time horizons, and thus assign artificially low discount parameters to future payoffs from joint cooperation with regulators. Such is likely to be the case if: (i) management compensation is tied to short term earnings, (ii) the firm experiences a cash flow problem that could threaten management's tenure, or (iii) managers are reaching the end of their tenure and a substantial portion of the reward payoff from joint cooperation will occur on subsequent managers' watch.[60] This agency problem is a classic feature in the literature on corporate governance,[61] and is no less prominent in game theoretic equilibria

58. Timing of elections and other key political events not only may affect discount parameters and thus maximize the value of short-term payoffs, but also may affect regulatory capture. An executive branch that is dependant on regulated industry for campaign contributions or other support may have a higher capture coefficient a and therefore a higher sucker payoff and a lower temptation payoff.

59. Although mutual defection will cause both players to receive a "punishment payoff," the political climate may be such that what is "punishment" to the agency is "reward" for political superiors in charge of the agency who relish political opportunities that come from legalistic battles.

60. Ayres & Braithwaite, *supra* note 21, at 78-79. Ayres and Braithwaite discuss a possible distinction between senior managers, who must play ball with regulators, and middle managers, who tend to have shorter time horizons and thus tend to be less cooperative. *Id.* As discussed in part II.B below, lawyers, and particularly in-house lawyers, can bridge this gap by communicating the cooperative strategies of senior managers to middle management. *See infra* part II.B.

61. In corporations, the separation of ownership from control may cause managers to not always act in the best interest of shareholders. *See* Adolf A. Berle & Gardiner C. Means, The Modern Corporation and Private Property 7 (1932). The system of corporate governance described by Berle and Means may not be as predominant in a market controlled by institutional investors. *See* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520, 522-25 (1990); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 Stan. L. Rev. 863, 863 (1991). Institutional investors, however, may not want to participate in corporate governance. *See* John C. Coffee, *Liquidity Versus Control:*

shaped by strategies that are for the most part chosen by a firm's managers rather than by its shareholders. Managers with short time horizons are thus more likely to assign a low discount parameter to future reward payoffs from cooperation and in turn are more likely to opt instead for defection. After suspecting this to be the case, regulators will effectively steer play toward joint defection, to avoid getting the sucker payoff.

B. *The New Players—Regulatory Lawyers*

This Article uses a model in which these games between firms and agencies in the Scholz model co-exist with similar games between lawyers representing agencies and lawyers representing firms. These multi-round lawyer-lawyer games extend over a period of time and cut across both individual client representations by firm lawyers and regulatory cases handled by agency lawyers. Because lawyers play their games at the same time as they advise clients on how to play the underlying firm/agency games, lawyer strategies influence client strategies and vice-versa.[62]

As with the agency/firm games described in section A, the game theoretic model could identify many Nash equilibria for lawyer-lawyer games. Two will be discussed further here:

(i) Joint cooperation
Agency lawyers cooperate with firm lawyers, do not instigate harassment of firms and discourage their political superiors from such harassment. Firm lawyers actively discourage defection by their clients, perhaps by resigning or even blowing the whistle when a client defects.

(ii) Joint defection
Agency lawyers encourage harassment of firms. Firm lawyers encourage and do not disclose firm defection and may actively facilitate firm defection.

The Institutional Investor as Corporate Monitor, 91 Colum. L. Rev. 1277, 1287 (1991) (stating that institutional investors prefer liquidity over control); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 Colum. L. Rev. 795, 798-99 (1993).

62. Firm lawyer/agency lawyer games could be modelled as prisoner's dilemmas similar to the firm/agency strategic form game in Figure 1 or the firm/agency extensive form game in *supra* note 30, with each lawyer having a choice between "cooperation" and "defection." Two-by-two normal form games such as the prisoner's dilemma, chicken, and the battle of the sexes, have their limitations, however. Indeed, "[a] problem that may look like a prisoner's dilemma or some other simple two-by-two game may be part of a much larger game. One cannot assume that, once embedded in a larger game, the play of the smaller game will be the same." Baird, *supra* note 4, at 45. Introducing lawyers into a firm/agency game is a good illustration of this point; firm/agency games and firm lawyer/agency lawyer games are embedded in each other in a way that may fundamentally change play in both. Furthermore, although this Article uses the prisoner's dilemma to model firm lawyer/agency lawyer interaction and to illustrate the utility of game theory for understanding such interaction, other games could be equally informative.

The joint cooperation equilibrium is more probable if: (i) firm lawyers and agency lawyers are repeat players who deal with each other on multiple occasions, (ii) noncooperative conduct by either is easy to detect, and (iii) information about lawyers' reputations is readily available. The joint defection equilibrium may evolve if: (i) firm lawyers or agency lawyers are not repeat players, (ii) noncooperative conduct by lawyers is difficult to detect, or (iii) information about lawyers' reputations is not readily available. Joint defection thus is particularly likely if lawyers who are unlikely to defect cannot successfully distinguish themselves from other lawyers. Furthermore, agency lawyers are very likely to defect in their play with firm lawyers who have a reputation for noncooperative strategies. Not only are these lawyers likely to defect frequently, but regulated firms which intend to defect are likely to hire these lawyers.

For individual lawyers, the payoffs from these different equilibria—the amount in each of the boxes in their own strategic form games—will vary with the nature of their practice and the type of clients they represent. When lawyers represent clients who themselves seek to stabilize a joint cooperation equilibrium with agencies, the lawyers will want to help ease regulatory burdens for their clients and thus may themselves realize high payoffs from their own cooperation with agency lawyers. When lawyers represent clients whose play with agencies has or will devolve to a joint defection equilibrium, however, the lawyers will not realize high payoffs from cooperating with agency lawyers. Indeed, such cooperation will irritate clients and could even cause the lawyers to be discharged.

Because lawyers play their own games cutting across client representations at the same time as they participate in formulation of client strategies, firm lawyer/agency lawyer games influence the outcome of the underlying firm/agency games. First, both firm and agency lawyers can influence whether regulatory capture occurs, and if it does, whether efficient, inefficient, or zero-sum capture is the most likely outcome. Second, even if a regulated firm is not a repeat player, which makes a joint defection equilibrium between agency and firm particularly likely, the firm's lawyers almost always are repeat players. A joint cooperation equilibrium may thus evolve between firm lawyers and agency lawyers and spill over into the game between the firm and the agency. If the regulated firm is a repeat player in the regulatory game with the agency, introduction of lawyers into the game could strengthen the stability of a joint cooperation equilibrium that already has evolved or cause a joint defection equilibrium to tilt toward joint cooperation. Using their extensive experience playing regulatory games, lawyers might help agencies and firms find the self-evident way to play[63] that brings them closer to a Pareto optimal equi-

63. *See* Kreps, Game Theory, *supra* note 4, at 134-35.

librium. Third, lawyers can play a more ominous role in both their own and their clients' games, particularly if they assume a more litigious disposition, causing joint cooperation equilibria to tilt toward joint defection. As will be discussed further in part II.C. below, rules of professional responsibility, as well as social and cultural norms within the legal profession, influence the equilibria that evolve once firm lawyer/agency lawyer games are superimposed on firm/agency games.

1. Lawyer Play Influencing Agency Play—The Capture Paradigm

Lawyers working in regulatory agencies usually have a lower susceptibility to inefficient and zero-sum capture[64] than their political superiors. First, these lawyers do not benefit, at least not directly, from the lobbying and campaign contributions that capture their political superiors. Furthermore, agency lawyers, like other lawyers, invest substantial human capital in building a reputation for thoroughness, integrity, and zealous representation of their clients. This reputational paradigm is reinforced by values of the legal profession that accord the most respect to the toughest government lawyers, and not to the weakest or most accommodating. One of the best examples is former United States Attorney Rudolph Giuliani, whose aggressive and often criticized tactics against insider traders and other white collar criminals earned him the enmity of Wall Street, but who had no trouble landing a high paying job with a New York firm prior to his election as Mayor of the City of New York.[65] Similarly, Gary Lynch, one of the most aggressive enforcement division chiefs at the SEC in recent memory, is now a much sought after partner of Davis Polk & Wardwell.[66] Former OTS Chief Counsel Harris Weinstein, once derided by bar associations for his 1992 attachment of a law firm's assets in an enforcement proceeding, has returned to a successful practice at Covington & Burling.[67] By contrast, a reputation for being a "push

64. Susceptibility to capture is reflected in the capture quotient α. For the capture formula, see *supra* note 54.

65. Giuliani first earned a reputation as a tough lawyer while working at the Justice Department in the early 1980s. In 1983, Giuliani returned to New York as a United States Attorney. In 1992, Giuliani joined Anderson Kill Olick & Oshinsky, with a salary of $350,000 a year. *See* Michael Powell, *Knows How He's Doin'*, Newsday, Jan. 3, 1994, at 3, 10A.

66. *See* Linda Himelstein, *Gary Lynch—'Just The Facts Ma'am'*, Bus. Wk., Aug. 8, 1994, at 60-61. Gary Lynch worked for the SEC for 13 years and was the enforcement chief during his last four years at the SEC. *Id.* at 61. Lynch earned his reputation by bringing charges against Ivan F. Boesky and Michael R. Milken. *Id.* at 60. In 1989, Lynch resigned from the SEC and accepted a lucrative job as a partner at Davis Polk & Wardwell, where he has represented Kidder, Peabody & Co. in connection with a government securities trading scandal and Nomura in connection with alleged securities laws violations. *Id.* at 60-61.

67. *Today's News: Update*, N.Y. L.J., Dec. 23, 1992, at 1 [hereinafter *Today's News*]; *Weinstein Resigns From OTS; Plans To Depart By December 26*, Office of Thrift Supervision News Release, Dec. 14, 1992 [hereinafter *Weinstein Resigns*] (on

over" while working for an agency may curry short-term favor with the private sector, but is unlikely to enhance a lawyer's professional reputation with those who remember him as a less than formidable opponent.

Standards of professional conduct also accord a high value to client loyalty and zealous representation, and emphasize the obligation of a government lawyer to protect the public interest and not simply act out of political expediency.[68] Finally, the fact that most high-ranking lawyers at regulatory agencies could earn more in the private sector makes them less worried about losing their jobs and perhaps less likely to succumb to pressures from "captured" political superiors. None of these factors will entirely isolate agency lawyers from capture, but each helps make agency lawyers less prone to capture than their political superiors. In many instances, an agency that is dominated by a highly respected staff of lawyers will be less likely than an agency dominated by political appointees to play a cooperative strategy against a regulated firm that has chosen to defect.

At the same time, agency lawyers *are* prone to *efficient* capture.[69] They may be less inclined than their political superiors to be overzealous in their enforcement efforts or to choose a strategy of harassment against a firm that has chosen to cooperate. The political rewards for harassment are not as likely to benefit lawyers, except to the extent that such rewards are passed on from political superiors in the form of raises, promotions, and the like. Indeed, the lawyers may someday hope to work for the firms that are the objects of such harassment. Competence and zealous representation of the public interest are one thing, but giving a firm that has chosen to cooperate the sucker payoff is quite another. Although some agency lawyers will do anything to

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file with the *Fordham Law Review*). Harris Weinstein was an associate at Covington & Burling from 1962 to 1967, and from 1967 to 1969 served as an assistant to the Solicitor General of the United States. *See Weinstein Resigns*, *supra*. In 1969, he returned to Covington & Burling, was made a partner in 1971, and remained there until 1990 when he became Chief Counsel at the OTS. *Id.* In 1992, Weinstein returned to Covington & Burling. *Today's News*, *supra*, at 1. For a discussion of enforcement proceedings brought by Weinstein on behalf of the OTS against lawyers and other professionals, see *infra* notes 128-36 and accompanying text; *see also* Scott J. Paltrow, *The Revolving Door*, L.A. Times, Mar. 13, 1994, at D1 (discussing private sector jobs landed by several top government enforcement officials, including former SEC Chairman David Ruder at Baker & McKenzie).

68. Catherine J. Lanctot, *The Duty of Zealous Advocacy and the Ethics of the Federal Government Lawyer: The Three Hardest Questions*, 64 S. Cal. L. Rev. 951, 955 (1991). Canon 7 describes the duty of loyalty as one of "zealous representation," yet government attorneys, perhaps even more than other lawyers, should "temper their advocacy in the interests of 'justice.'" *Id.* at 955 & n.12; *see* Model Code of Professional Responsibility Canon 7 (1995) [hereinafter Model Code].

69. For a discussion of the modelling of efficient capture, see *supra* note 53 and accompanying text. Efficient capture, by reducing the value of the temptation payoff to the agency, can cause a joint-defection equilibrium to shift toward a joint-cooperation equilibrium.

curry favor with their political superiors, the reputational paradigm will distinguish between an agency lawyer known to be a "tough opponent" and one widely regarded, in more colloquial language, to be a "jerk." An agency lawyer, perhaps more than her political superiors, also is likely to recognize a good argument for regulatory flexibility and to recognize when the firm making that argument is itself playing a cooperative strategy. The negotiation skills and astuteness of agency lawyers thus can have a significant role in promoting an objective that Ayres and Braithwaite seek to accomplish through other means:[70] "a socialization of regulators that renders them more open to lobbying that promotes efficient capture, more resistant to lobbying that promotes zero-sum, and inefficient capture."[71] This ideal of "regulatory reasonableness,"[72] or the middle ground between agency capture and agency opportunism, is more likely to be realized when lawyers have a significant role in choosing an agency's strategies than when they do not.

2. Lawyer Play Influencing Firm Play

Lawyers are likely to exert a stabilizing influence on firm strategies as well. Lawyers benefit much less, and can be hurt much more than their clients, by firm opportunism that leaves a regulatory agency with the sucker payoff. The lawyers probably will deal with the same agency in the future not only on behalf of that client, but also on behalf of other clients. If the agency blames a client's defection on the lawyer, or believes that the lawyer could have done something to prevent it, other clients may have difficulty achieving an equilibrium of joint cooperation with the agency when represented by the same lawyer. For example, a federal communications lawyer who has made enemies at the Federal Communications Commission ("FCC") is not a particularly good choice for a communications firm seeking cooperation with the FCC.[73] If the majority of a lawyer's clients seek cooperative play with the FCC, the lawyer thus will probably choose to cooperate consistently with the agency. Other clients will probably have to conform to this cooperative strategy or look elsewhere for counsel.

70. Ayres and Braithwaite focus on reducing inefficient and zero-sum capture and encouraging efficient capture through industry-agency dialogue and public interest group participation in the regulatory process. *See* Ayres & Braithwaite, *supra* note 21, at 71-75.

71. *Id.* at 70.

72. *Id.* at 68.

73. *See* Emerson, *supra* note 19, at 243-44. The FCC clearly relies on informal sanctions. "Communications lawyers, usually getting what they seek, generally need to remain chummy with the FCC rather than fight it .... The broadcast attorney seeks to show everything about his client that is wholesome and to the community's benefit while pointing out the opposite in any opponent." *Id.* (footnotes omitted). As of 1991, the FCC had only had two lawyer disciplinary hearings since its inception in 1934. *Id.* at 238.

Lawyers representing regulated firms also have skills in communicating with regulators that firm managers may lack. Their sophisticated understanding of the subject matter at stake and of the agency's policy objectives can be critical to the negotiation between players that facilitates cooperative play.[74] Indeed, one of the most valuable services that firm lawyers may provide, particularly if they have previous experience representing regulatory agencies, is guidance toward that elusive self evident way to play that brings clients closer to a Pareto optimal equilibrium.[75]

Lawyers on both sides of the regulatory game thus have the potential to assist the players in establishing and stabilizing an equilibrium of joint cooperation. In single-round games between agencies and firms, joint defection is almost certain unless firm lawyers can induce firm cooperation in order to increase the value of future rounds that the lawyers will play with the same agencies on behalf of other clients. In multi-round games between agencies and firms, agency and firm lawyers are particularly likely to facilitate negotiation toward cooperative equilibrium and to discourage opportunism. Because leaving the other player with the sucker payoff usually benefits lawyers far less than such a strategy benefits firm managers and agency political superiors, each side is likely to fear the other's opportunism less when lawyers have a significant role in choosing and implementing strategies. Once firms and agencies decide on cooperation, lawyers can help them find self-evident ways to play that sustain cooperation and benefit everyone.

3. Agency Lawyer and Firm Lawyer Defection

So much for the good news that lawyers have a powerful potential to induce firms and regulators to choose the Nash equilibrium of joint cooperation. As David Kreps observes, however, "Unless a given game has a self-evident way to play, self-evident to the participants, the notion of a Nash equilibrium has no particular claim upon our attention."[76] Furthermore, if a game has more than one Nash equilibrium, it can be very difficult to predict which one the players will choose.[77] Simply because one equilibrium maximizes each player's wealth, does not mean that players will choose it—indeed, the equilibrium that most game theorists would predict in a prisoners' dilemma game with only a few rounds would be joint defection,[78] not joint co-

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74. "[T]he conditions for Nash equilibrium are that players are relatively certain how their opponents will act." Kreps, Game Theory, *supra* note 4, at 140. Players will see that a particular mode of behavior will be followed by other players if the players "have *the opportunity to negotiate before play* of the 'game.'" *Id.*

75. *Id.* at 134-35.

76. *Id.* at 31.

77. *Id.*

78. "[E]ach will probably choose the 'non-cooperative action,' since there is no way to bind the other party or for the other party to inflict on the first some form of

operation. Joint cooperation and joint defection are also only two of the many possible Nash equilibria in lawyer/lawyer as well as firm/agency games—and joint cooperation is by no means the self-evident way to play. Lawyers are not always more inclined than their clients to choose cooperation; while some lawyers choose cooperative strategies in their own play with regulators and encourage their clients to do the same, others exacerbate the distrust between agencies and firms which inevitably leads to joint defection.

Some agency lawyers simply do not want to play cooperatively, even if firm lawyers are playing cooperatively. Agency lawyers could be overworked and not have time to distinguish between cooperation and defection on the part of firm lawyers. Alternatively, agencies may delegate too much discretion to less experienced lawyers who cannot recognize when firm lawyers are cooperating and who overcompensate for inexperience by assuming the worst from both firms and firm lawyers. Finally, agency lawyers may be constrained by inflexible procedures that do not allow them to reciprocate cooperative play by firm lawyers. For example, rules may require that bank examinations be carried out frequently, in a relatively burdensome manner, with little room to adjust the level of scrutiny or make exceptions to rules, regardless of the bank involved or the lawyers the bank has chosen to represent it.

On the firm lawyer side, some lawyers facilitate the most extreme form of firm defection—outright illegal conduct—perhaps the worst example being lawyers who make misrepresentations to federal regulators on behalf of savings and loans.[79] In addition, bar associations sometimes interpret rules of professional conduct to justify and even require lawyer defection from cooperative play with regulators when clients engage in improper conduct.[80] Such defection may improve a

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punishment." *Id.* at 29. Theoretically at least, a prisoner's dilemma game with a known, finite number of rounds, will devolve into mutual defection. *Id.* at 70.

79. John H. Cushman, Jr., *Paul, Weiss Law Firm to Pay U.S. $45 Million*, N.Y. Times, Sept. 29, 1993, at D1. Aggressive enforcement actions were brought by the OTS and Resolution Trust Corporation ("RTC") in the wake of the savings and loan debacle of the late 1980s and early 1990s. Most of these actions alleged that attorneys who represented failed institutions facilitated their clients' efforts to mislead federal regulators. Almost all of these actions against law firms were settled prior to trial, and settlements totaled over $200 million. These include settlements against Jones, Day, Reavis & Pogue ($50 million), Paul, Weiss, Rifkind, Wharton & Garrison ($45 million), Kaye, Scholer, Fierman, Hays & Handler, in a case which is discussed more extensively in the section that follows ($41 million), and Troutman, Sanders, Lockerman & Ashmore ($20 million). *Id.* Settlements by accounting firms included Ernst & Young ($128 million) and Arthur Andersen ($65 million). *Id.* The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), enacted after much of the conduct in these actions was alleged to have occurred, now expressly includes attorneys within its definition of "institution-affiliated part[ies]" subject to OTS enforcement remedies. 12 U.S.C. § 1813(u)(4) (1994).

80. *See* Working Group on Lawyers' Representation of Regulated Clients, ABA, Report to the House of Delegates (1993) (concerning the Kaye, Scholer matter and

client's payoffs in a single round of play, but leads regulators to anticipate future defection not only by those particular lawyers, but by lawyers in general. Regulators in turn are tempted to believe that lawyer defection will follow client defection because lawyers believe such defection to be not only an acceptable strategy, but an obligation. Absent a yardstick for determining which lawyers will defect in these circumstances, and which will not and instead resign or blow the whistle, agency lawyers will avoid the sucker payoff by choosing strategies that reflect their trust in the regulated client, not its lawyer.

Furthermore, even if lawyers will not acquiesce in the type of extreme client defection that involves clear violation of law, agency problems may encourage lawyers to steer their clients away from a cooperative strategy. The punishment payoff in games between firms and agencies, described as "Legalistic Battles" in Figure 1, often translates into more billable hours for firm lawyers. Consequently, it may not matter that the lawyers participating in or instigating these legalistic battles are themselves receiving the punishment payoff in play with agency lawyers. The lawyers may fear that the alternative, firm/agency cooperation, will deny lawyers opportunities to play at all.

Some lawyers may also value the opportunity to score a highly visible victory against regulators and enhance their own reputational capital, even if the aggregate payoff for their client from such a strategy is lower than the payoff from joint cooperation. Alternatively, some lawyers may not be wealth maximizers; they may enjoy conflict for its own sake and act accordingly. As David Kreps observes, "Money is not everything to every player, and models of competitive situations, if they are to be useful models of reality (i.e., predict behavior, in real contexts) must take this into account as best they can."[81] Lawyers, perhaps more than other players, may derive satisfaction from jousting with regulators, even though winning an argument with a regulator over a technical point or obstructing an investigation can be a Pyrrhic victory for clients who risk getting the punishment payoff in future rounds.

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others like it). The Working Group complains that, among the OTS's "novel theories of professional responsibility" is the notion that lawyers have an obligation to report misconduct to superiors, going "all the way to the client's board of directors." *Id.* at 6-7. Regulators, according to the Working Group, are also wrong to "seek to impose a duty of due diligence on lawyers with respect to the accuracy of any statements made to federal banking agencies by *the lawyers.*" *Id.* at 7 (emphasis added). Finally, "the regulators have sometimes taken the view that the lawyer must resign if his or her efforts to prevent the wrongdoing prove unsuccessful. The Working Group again believes this to be an incorrect reading of [Model] Rule 1.13 and [Model] Rule 1.16." *Id.* The Working Group takes this position despite the fact that the ABA's own ethics opinions require a lawyer to withdraw when her services will further a client's fraud. *See* ABA Comm. on Ethics and Professional Responsibility, Formal Op. 366 (1992) (advocating withdrawal when a lawyer's services will otherwise be used to perpetrate a fraud).

81. Kreps, Game Theory, *supra* note 4, at 120.

C. *How Convention, Rules, and Professional Ideology Shape Equilibria in Lawyer Games*

The discussion in part I.B illustrates how play between firm lawyers and agency lawyers, like firms and agencies, can gravitate toward an equilibrium of joint cooperation or an equilibrium of joint defection. In some circumstances, lawyers' reputations alone give them a powerful incentive to cooperate. In other circumstances, however, reputational incentives will not deter defection, and legal rules or other external incentives for cooperative conduct can help steer firm lawyers and agency lawyers toward a cooperative equilibrium. In still other circumstances, legal rules or other external influences may steer lawyers toward an equilibrium of mutual defection.

Rules of professional responsibility are an important source of focal points[82] in firm lawyer/agency lawyer games. Some mandatory rules steer lawyers toward mutual cooperation by prohibiting or circumscribing both (i) firm lawyer conduct that facilitates a client's defection from cooperative play with an agency and (ii) firm lawyer conduct that is itself defection from cooperative play with agency lawyers. Such rules prohibit a lawyer from assisting a client in a crime or fraud,[83] prohibit a lawyer from misrepresenting law or facts to a judicial or administrative tribunal,[84] require a lawyer to disclose a client's

82. Moral codes can motivate players to adhere to a specific path of conduct, or "focal-point." *See* Christina Bicchieri, *Norms of Cooperation*, 100 Ethics 838, 848 (1990); Philip Petit, *Virtus Normativa: Rational Choice Perspectives*, 100 Ethics 725, 733 (1990). A focal point, also referred to as a *Schelling Point*, is "the combination of *strategies* that players are likely to choose because it is especially prominent under the conditions and culture in which the players find themselves." Baird, *supra* note 4, at 307. For the origin of this phrase, see Thomas C. Schelling, The Strategy of Conflict (1960).

83. *See* Model Rules of Professional Conduct Rule 1.2(d) (1995) [hereinafter Model Rules]; Model Code, *supra* note 68, DR 7-102(A)(7).

84. *See* Fed. R. Civ. P. 11.

perjury,[85] and require a lawyer to resign from representing a client under certain circumstances.[86]

Other rules facilitate detection and punishment of lawyer defection. These rules usually require a lawyer possessing unprivileged knowledge of an ethical violation by another lawyer to report such knowledge to a tribunal or authority empowered to investigate the situation.[87] This reporting requirement helps counteract the "norm"[88] of silence that can steer firm lawyer/agency lawyer games to a defect/defect equilibrium, or even to a defect/cooperate equilibrium[89] if

85. Both the Model Code and the Model Rules clearly prohibit a lawyer from knowingly presenting false testimony or false evidence at a trial or an administrative proceeding. Under Model Code DR 7-102(B)(1), however, a lawyer's duty to reveal past perjury is apparently subordinate to the lawyer's duty not to reveal privileged communications. *See* Model Code, *supra* note 68, DR 7-102(B)(1); *see also* ABA Comm. on Ethics and Professional Responsibility, Formal Op. 341 (1975) (interpreting the words "privileged communication" in DR 7-102(B)(1) to include both "confidences," meaning information communicated to the lawyer by the client, *and* "secrets," meaning any other information learned in the course of the professional relationship). Model Rule 3.3 reversed this position. According to ABA Formal Opinion 87-353:

> It is now mandatory, under these Model Rule provisions, for a lawyer, who knows the client has committed perjury, to disclose this knowledge to the tribunal if the lawyer cannot persuade the client to rectify the perjury . . . the obligation of a lawyer to disclose to the tribunal client perjury committed during the proceeding, which the lawyer learns about prior to the conclusion of the proceeding, represents a reversal of prior opinions of this Committee given under earlier rules of professional conduct.

ABA Comm. on Ethics and Professional Responsibility, Formal Op. 353 (1987). More recently, ABA Formal Opinion 376 addressed situations where a client lies in response to discovery requests. The ABA recommends the same course of action it would at trial: attempted persuasion and withdrawal, and if these approaches fail, disclosure to opposing counsel or to the court. ABA Comm. on Ethics and Professional Responsibility, Formal Op. 376 (1993). Also, Model Rule 3.9 provides that a lawyer shall conform to Rule 3.3 when representing a client in a legislative or administrative proceeding. *See* Model Rules, *supra* note 83, Rule 3.9.

86. *See* Model Rules, *supra* note 83, Rule 1.16; Model Code, *supra* note 68, DR 2-110(B). Model Rule 1.16(a) provides that a lawyer shall not represent a client, and shall withdraw from a representation that has commenced if the representation will violate rules of professional conduct. Perhaps the best example of such a violation is when the representation would conflict with a concurrent or previous representation of another person by the same lawyer. Model Code DR 2-110(B) also explicitly states that withdrawal is required where the lawyer knows that her client is bringing an action or asserting a defense "merely for the purpose of harassing or maliciously injuring any person." Model Code, *supra* note 68, DR 2-110(B).

87. *See* Model Code, *supra* note 68, DR 1-103(a); Model Rules, *supra* note 83, Rule 8.3(a); *In re* Himmel, 533 N.E.2d 790, 791, 796 (Ill. 1988) (suspending a lawyer from practice for one year for violating DR 1-103(a)).

88. For a discussion of ideological norms of the profession, see *infra* notes 96-98 and accompanying text.

89. For example, an inexperienced agency lawyer might be intimidated by a more experienced firm lawyer and not know how to retaliate, yet not want to report the firm lawyer's misconduct. Also, even if a lawyer working for an agency can retaliate for a firm lawyer's defection by increasing regulatory scrutiny of the lawyer's clients, such retaliation might expose the agency lawyer to charges of harassment. *See* Susan Beck, *Keating's Bouncer*, Am. Law., Jan.-Feb. 1990, at 40, 45 (describing how Kaye,

there is little confidence that lawyers who defect while others cooperate will be reported and punished *ex post*.[90] Although the reporting requirement may thus restore confidence that lawyer defection will be detected and punished, this requirement could also have the opposite effect of fostering distrust among lawyers. Such distrust is particularly likely if the reporting requirement provides apparent justification for lawyers who file malicious or unfounded disciplinary reports either out of spite or to achieve tactical advantage in litigation.[91]

Furthermore, although some rules of professional conduct facilitate cooperative play, other rules have the opposite effect because they make it difficult for one lawyer to determine if another lawyer has defected. For example, rules prohibiting a lawyer from disclosing client misconduct may help conceal lawyer complicity in that conduct, even though such complicity violates other rules of professional responsibility.[92] Lawyer defection from cooperative play thus is difficult to detect in circumstances where the lawyer may not disclose the de-

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Scholer repeatedly threatened the Federal Home Loan Bank Board ("FHLBB") with lawsuits in order to deflect a regulatory crackdown on Lincoln Savings and Loan).

90. Of course, an agency lawyer may have at her disposal the means to punish a defecting firm lawyer without reporting that lawyer's conduct to the appropriate authorities. If so, reporting may not be needed as a deterrent.

91. Bad faith reporting is a serious problem in the profession:

> It bears emphasis that this right to report misconduct, though generally serving the salutary purpose of assisting courts, disciplinary agencies and other authorities in policing members of the bar, is unquestionably susceptible to abuse by attorneys seeking to gain advantages or concessions from other lawyers in the course of litigation, in private business transactions, or in interpersonal relationships, or by attorneys acting purely out of spite.

N.Y. St. B.A. Comm. on Professional Ethics, Op. 635 (1992). As pointed out by Professor Geoffrey Hazard:

> Another development raising questions about the mandatory reporting rule emerging in several jurisdictions is the practice of filing a disciplinary charge whenever a dispute between lawyers gets heated. The result has been a surge of petty disciplinary matters. These grievances are ostensibly justified but often are motivated by anger or vengefulness. They add a burden to overloaded disciplinary systems and corrode already fragile relations within the bar.

Geoffrey C. Hazard, *"Squeal Rule" Considered for Change*, Nat'l L.J., Mar. 26, 1990, at 13, 14. One factor that may help reduce the number of bad faith disciplinary complaints was the ABA's interpretation of Model Rule 8.3, requiring that reporting be prompt and without delay. *See* ABA Comm. on Ethics and Professional Responsibility, Formal Op. 383 (1994) (stating that "[a] lawyer who becomes aware of professional misconduct that raises a substantial question as to a lawyer's honesty, trustworthiness or fitness as a lawyer in other respects should report that misconduct promptly, to the extent required by Rule 8.3(a), and not use it as a bargaining chip in [a] civil case").

92. Model Rule 1.6 permits disclosure of confidential client information only to prevent commission of a crime likely to result in death or substantial bodily harm. If the client only intends to commit fraud or crimes causing financial injury, disclosure is not permitted. In some situations, a lawyer may be compelled to withdraw from representing a client because Model Rule 1.2(d) states that "[a] lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent." Model Rules, *supra* note 83, Rule 1.2(d).

fection of his client in the underlying game. Not only is the defection of both lawyer and client more likely to go undetected, but, even if the lawyer's defection is discovered, the lawyer can argue that his own options were limited by prohibitions on disclosure of client confidences.

Even non-binding rules of professional responsibility can be significant. An important difference between game theory and the contractarian theory discussed later in this Article[93] is that in game theory a rule need not be binding in order to influence interaction between two or more persons. Thus, a rule which is not enforced through disciplinary measures, for example an Ethical Consideration in the Model Code of Professional Responsibility, can become a focal point and change the way lawyers behave.[94]

Another important source of focal points is ideological norms in the profession, whether or not these norms are incorporated into rules of professional conduct.[95] For example, lawyers may generally believe that loyalty to clients is more important than playing cooperatively with one another.[96] If so, it may not make much difference that a firm

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The predecessor to the Model Rules, the ABA Model Code of Professional Responsibility, is somewhat more flexible, allowing disclosure when a client intends to commit a crime. "A lawyer *may* reveal: . . . (3) [t]he intention of his client to commit a crime and the information necessary to prevent the crime." Model Code, *supra* note 68, DR 4-101(C) (emphasis added). The Model Code does not, however, allow disclosure when the intended conduct is an intentional tort, a civil fraud, or any other act which does not amount to a crime. *See* Model Code, *supra* note 68, DR 4-101. The Model Code, like the Model Rules, is permissive; under no circumstances is a lawyer required to disclose. Finally, the Model Code, like the Model Rules, does not allow disclosure in order to rectify results of past crimes. Although DR 7-102(A)(7) states that "In his representation of a client, a lawyer shall not: . . . (7) [c]ounsel or assist his client in conduct that the lawyer knows to be illegal or fraudulent," the Code does not require a lawyer who has already done so to reveal the client's crime or fraud.

93. *See infra* note 100 and accompanying text.

94. I will argue in another paper that, for this reason, the drafters of the Model Rules of Professional Responsibility erred in not retaining the Ethical Considerations of the Model Code. *See* Richard W. Painter, *Contractarianism and Game Theory in Professional Responsibility: Should Lawyers and Clients Play By Immutable or Default Rules?* (unpublished manuscript).

95. David Kreps, in his analysis of game theory, discusses several factors that can create strategic uncertainties and steer players toward a certain mode of play, whether or not that mode of play is optimal. One of these factors is social convention. Kreps gives the example of a Korean student and a Korean professor bargaining over poker chips; a game which the Korean professor presumably almost always will win. *See* Kreps, Game Theory, *supra* note 4, at 142-43.

96. As Lord Brougham stated in the Trial of Queen Caroline:

> An advocate, in the discharge of his duty, knows but one person in all the world, and that person is his client. To save that client by all means and expedients, and at all hazards and costs to other persons, and, among them, to himself, is his first and only duty; and in performing this duty he must not regard the alarm, the torments, the destruction which he may bring upon others. Separating the duty of a patriot from that of an advocate, he must go on reckless of consequences, though it should be his unhappy fate to involve his country in confusion.

lawyer could maximize her own payoff from multi-period games by continuing to cooperate with agency lawyers. The lawyer will not want to be looked upon as a "traitor" or a "snitch" when a bad client comes along, even if doing so might significantly increase her value to "good" clients.[97] If so, when clients defect in underlying games, lawyers are more likely to follow suit and defect in their own games as well. Thus, at times, ideological norms within the legal profession will steer play between lawyers to an equilibrium of mutual defection.

One of the most powerful influences on whether play between lawyers and regulators will evolve toward mutual cooperation, mutual defection, or some other equilibrium, is whether the players have an opportunity to negotiate before play begins.[98] Negotiation of contractual commitments that are clearly understandable and enforceable can shift play from focal points suggested by rules of professional conduct and ideological norms toward new modes of behavior. Contractual commitments can also change the rules of the game by changing the players' payoffs or the range of strategies available to players. The process of creating these new rules is where game theory meets Coasian contractual theory, the topic of the next part of this Article.

III. The Contractarian Paradigm

A. *Is There a Role for Lawyers in Contractual Theory?*

Coasian contractual theory has significantly influenced legal scholarship in such areas as business organizations, securities regulation, and contracts.[99] Contractual theory also contributes greatly to our understanding of game theory by modeling the process by which players can steer play toward an equilibrium of joint cooperation as they negotiate their respective strategies.[100] Even a single-round prisoner's dilemma game may settle into a cooperative equilibrium if the players are allowed an opportunity to commit to cooperate.[101] Although Coa-

2 The Trial Of Queen Caroline 8 (J. Nightingale ed., Albion Press, London 1821), *cited in*, Charles Fried, Right and Wrong 177 (1978).

97. *See* Richard W. Painter, *Toward a Market for Lawyer Disclosure Services: In Search of Optimal Whistleblowing Rules*, 63 Geo. Wash. L. Rev. 221, 267-74 (1995).

98. *See supra* note 74.

99. *See* Charles R. O'Kelley, Jr., *Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis*, 87 Nw. U. L. Rev. 216 (1992); *see also* Robert E. Scott, *The Case for Market Damages: Revisiting the Lost Profits Puzzle*, 57 U. Chi. L. Rev. 1155 (1990) (discussing preferred default rules for damages in contracts).

100. *See supra* note 74. As Gilson and Mnookin observe in their game theoretic analysis of litigation, "[b]oth parties to a lawsuit with a prisoner's dilemma payoff schedule would like to hire cooperative lawyers because that allows them to commit to a cooperative strategy." Gilson & Mnookin, *supra* note 22, at 525. The same is true for both parties to a firm/agency relationship. The contractarian paradigm discussed in this Article should explain how firm lawyers and agency lawyers can reach agreement about exactly what is a cooperative strategy for each.

101. "[T]he set of Nash equilibria contains the set of credibly self-enforcing agreements that could be made." Kreps, Game Theory, *supra* note 4, at 32.

sian contractual theory appears in scholarship related to the conduct of lawyers in such matters as insider trading[102] and whistleblowing,[103] the relationship between lawyers and regulators is not generally viewed in contractual terms. A contractarian, however, would view the regulatory process as part of a "bargain" between regulators, regulated firms, and lawyers.

The role of lawyers in the contractarian paradigm, however, is severely limited by the fact that lawyers ordinarily do not contract with persons who are not their clients; indeed, contractual commitments to third parties often are believed to compromise the lawyer-client relationship.[104] In the relatively few scenarios where lawyers may commit themselves to third parties—for example, through opinion letters and escrow agreements—lawyers can induce joint cooperation between their clients and third parties by making credible promises where promises from their clients would not be credible.[105] Lawyers, however, could bargain far more extensively if they had freedom to opt in to standards of professional conduct that expand their own obligation to protect third parties. Lawyers thus could induce third parties, such as regulators, to play cooperative strategies in firm/agency games in return for the lawyers committing themselves *in advance* to cooperative strategies that discourage client defection and mitigate injury in the event that a client defects.[106] On the other hand, immutable rules of professional conduct may prevent the lawyer from committing herself to a cooperative strategy *ex ante* by imposing a client loyalty norm

102. *See* Stephen M. Bainbridge, *Insider Trading Under the Restatement of the Law Governing Lawyers*, 19 J. Corp. L. 1 (1993) (discussing whether lawyers could contractually commit to clients that they would not trade on inside information). Jonathan Macey and Geoffrey Miller have modeled ethical rules governing attorney conflicts of interest as default rules that reduce contracting costs between lawyers and their clients. *See* Jonathan R. Macey & Geoffrey P. Miller, *An Economic Analysis of Conflict of Interest Regulation* (unpublished manuscript).

103. *See* Painter, *supra* note 97, at 256-57.

104. Model Rule 1.7(b) provides in pertinent part: "A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client *or to a third person* . . . ." Model Rules, *supra* note 83, Rule 1.7(b) (emphasis added).

105. An opinion letter may commit a lawyer to make representations about certain factual or legal circumstances, at least to the extent of the lawyer's knowledge as of the date of the opinion, and an escrow agreement may commit the lawyer acting as escrow agent to pay money over to a third party when certain conditions are met. Such instruments are most commonly used in circumstances where a similar promise from the lawyer's client would not be credible. The ABA has sought to standardize opinion language and procedures. *See* ABA Comm. on Legal Op., *Third-Party Legal Opinion Report, Including the Legal Opinion Accord, of the Section of Business Law, American Bar Association*, 47 Bus. Law. 167, 169, 176 (1991). This ABA Opinion Accord is sometimes referred to as the "Silverado Accord." While a legal opinion does not have to conform to the guidelines set forth in the Silverado Accord, the Accord seeks to define preferred opinion writing practice, and an opinion letter may incorporate provisions of the Accord by reference. *Id.* at 170.

106. For example, lawyers could commit themselves *ex ante* to blow the whistle if a client lies to regulators. *See* Painter, *supra* note 97, at 258.

in which lawyer defection almost always automatically follows client defection. In such situations, unless the regulated firm alone is able to convince the regulator that it will play a cooperative strategy, the agency lawyer will assume that a firm's lawyer will defect along with the firm, and joint lawyer defection is the most likely outcome.

B. *The Role of Lawyers in the Paradigm of Enforced Self Regulation*

1. Self Regulation

Ian Ayres and John Braithwaite apply the insights of Ronald Coase to observe that government should only produce "public goods," such as regulatory enforcement, when "internal production" is cheaper than "external contracting."[107] Self regulation, if monitored by regulators and enforced with rewards and punishments, can be a form of "subcontracting regulatory functions to private actors."[108] Ayres and Braithwaite propose a model of "enforced self regulation" that involves negotiation between the state and individual firms in which each firm submits its own "tailored" standards for approval by regulators "to avoid harsher (and less tailored) standards imposed by the state."[109] Ayres and Braithwaite recognize that the independence of each firm's compliance group—the persons within a firm responsible for enforcing the standards—is an important component of self regulation, but can never be fully guaranteed. They suggest that "[t]he best guarantee of compliance group independence is external: making the failure to report unrectified violations a crime."[110]

As pointed out in the game theoretic discussion in part II of this Article, a firm's compliance with regulation can be facilitated, although by no means guaranteed, by the firm's lawyers. This part discusses how making firm lawyers part of the self regulation "contract" between regulatory agencies and firms facilitates compliance with regulatory standards. Moreover, in an enforced self regulation regime similar to that described by Ayres and Braithwaite, lawyers could also play a critical role in negotiations between the state and

107. Ayres & Braithwaite, *supra* note 21, at 102-03.

108. *Id.* at 103.

109. *Id.* at 101. Ayres and Braithwaite list several strengths of an enforced self regulation model compared with the traditional model of agency promulgated and agency enforced regulation: "rules would be tailored to match the company;" "rules would adjust more quickly to changing business environments;" "regulatory innovation would be fostered;" "rules would be more comprehensive in their coverage;" "companies would be more committed to the rules they wrote;" "confusion and costs that flow from having two rule books—private and public—would be reduced;" "business would bear more of the costs of its own regulation;" "more offenders would be caught more often;" "offenders who were caught would be disciplined in a larger proportion of cases than under traditional government regulation;" "it would be easier for prosecutors to obtain convictions;" and "compliance would become the path of least corporate resistance" for most regulated entities. *Id.* at 110-16.

110. *Id.* at 127.

individual firms submitting their own "tailored" standards for approval. Although the relationship between lawyers and regulators usually is not viewed in "contractual" terms, Ayres and Braithwaite's insights into the contractual aspects of the relationship between regulators and firms can be applied to lawyers as well.

Enforced self regulation of lawyers' clients thus could be much more effective if carried out in conjunction with similar regulation of the lawyers. Ayres and Braithwaite discuss the role of firm sponsored compliance groups in the self enforcement stage of the regulatory process, but only speak briefly of the professionals—lawyers and accountants—who are inevitably a part of the internal compliance groups at most firms. Integrating professionals into the enforced self regulation paradigm, however, could dramatically increase the success of this regulatory model, particularly in circumstances where regulators do not trust firms to police themselves. If professionals negotiate with regulators predictable standards for self-regulation, they can establish the level of trust required for an enforced self regulation regime to flourish for their clients as well.

2. The Lawyer-Agency "Contract"

Regulators sometimes insist that, although all lawyers are bound by codes of professional responsibility, lawyers who choose to represent regulated clients, and particularly lawyers who undertake to make certain disclosures for those clients, assume additional obligations.[111] Voluntarily assumed obligations thus can be as important to regulators' view of lawyers' responsibilities as they are to ordinary contracts. Nonetheless, regulators for the most part do not form actual contracts with lawyers setting forth exactly what lawyers' responsibilities are.[112] Instead, regulators rely on vague understandings that far too often become misunderstandings, leading to what the title of this Article refers to as "the uneasy relationship between regulators and regulatory lawyers."

In *In re Carter & Johnson*,[113] the SEC inferred a "quasi contractual" understanding from its relationship with an entire group of lawyers, those who practice securities law. Carter and Johnson represented National Telephone over the course of several years during which National ignored Carter's and Johnson's legal advice and persisted in repeated violations of the securities laws, including issuing false press releases, sending misleading letters to shareholders, and filing misleading disclosure statements with the SEC. The SEC's Release clearly stated that Carter and Johnson each had an obligation to take affirmative steps to correct National's disclosure violations, such as

111. *See infra* notes 113-35 and accompanying text.

112. *But see infra notes* 152-54 and accompanying text.

113. *In re* Carter & Johnson, Exchange Act Release No. 17,597 [1981 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,172 (Feb. 28, 1981).

approaching other members of National's board of directors or resigning.[114] The Release also recognized, however, that adequate standards for professional conduct in securities practice had not been sufficiently developed at the time,[115] an implicit acknowledgment that Carter and Johnson arguably were playing by the default rules in generalized codes of professional responsibility rather than by the more specific and stringent rules the SEC sought to impose on securities lawyers. Thus, the SEC did not sanction Carter and Johnson under Rule 2(e) of its Rules of Practice,[116] and instead dictated the terms that lawyers who practice at the bar of the SEC should abide by in the future:

> When a lawyer with significant responsibilities in the effectuation of a company's compliance with the disclosure requirements of the federal securities laws becomes aware that his client is engaged in a substantial and continuing failure to satisfy those disclosure requirements, his continued participation violates professional standards unless he takes prompt steps to end the client's noncompliance.[117]

The SEC did not seek to impose this duty to take "prompt steps to end the client's noncompliance" on all lawyers, but only on lawyers who choose to accept "significant responsibilities in the effectuation of a company's compliance with the disclosure requirements of the federal securities laws." In return for allowing lawyers to assume "significant responsibilities" with respect to securities filings, the SEC will require the lawyers to play by *its* rules, not merely the rules of professional responsibility applicable to lawyers generally.[118] As the SEC had pointed out in 1960,[119] and again in 1973, "The right to appear and practice before this Commission as an attorney is, like membership in the bar itself, a privilege burdened with conditions."[120] The

114. *Id.* Carter and Johnson warned National against this conduct, but did not resign or inform the SEC of their client's violations. *Id.* at 84,162-64.

115. *Id.* at 84,172.

116. Under Rule 2(e), the SEC may disqualify from appearing or practicing before it, temporarily or permanently, any attorney found to have violated or aided and abetted a violation of the securities laws or the rules and regulations thereunder. 17 C.F.R. § 201.102(e)(1)(iii) (1996).

117. *In re Carter & Johnson*, at 84,172.

118. At least as interpreted by the ABA, the Model Rules of Professional Conduct do not require either that a lawyer resign when a client engages in illegal conduct or that the lawyer make a report to the client's board of directors. *See supra* note 80.

119. *In re* Morris Mac Schwebel, 40 S.E.C. 347 (1960).

120. *Id.* at 371 (quoted in *In re* Fields, 45 S.E.C. 262, 266 n.20 (1973) (Rule 2(e) proceeding), *aff'd without opinion*, 495 F.2d 1075 (D.C. Cir. 1974)). The preamble to the Model Rules refers to a lawyer as "an officer of the legal system." Model Rules, *supra* note 83, Preamble. In choosing a practice area, a lawyer can be deemed to have chosen a particular legal system in which to practice and to have implicitly agreed to play by *that* system's rules. "A lawyer representing a client, as an officer of the legal system, must honor the obligations to the system by adhering to its rules. When the system in question is a regulated industry, the lawyer no longer has the option of choosing rules from the litigation system." W. Frank Newton, *A Lawyer's Duty to the Legal System and to a Client: Drawing the Line*, 35 S. Tex. L.J. 701, 720 (1994).

SEC's conditions, as stated in *In re Carter & Johnson*, require the lawyer for a recalcitrant client that is violating the securities laws, at a minimum, to confront the client's board of directors with the impropriety or to resign.

In *In re Kern*,[121] Allied Corporation, while the subject of a tender offer, began negotiations with a potential suitor, an event that had to be disclosed to the SEC.[122] The SEC alleged that Allied and Allied's lawyer, George Kern, failed to disclose these negotiations.[123] The usual or default rule is that the client, not the lawyer, is responsible for fulfilling its own disclosure obligations.[124] The administrative law judge, however, found that Kern had:

> assumed sole responsibility for determining when an amendment to Allied's Schedule 14D-9 would be filed . . . . In the usual relationship of lawyer and client Kern would have had only the responsibility of giving legal advice to . . . officers of Allied who in turn would have made the decisions whether amendments to Allied's Schedule 14D-9 were required. When Kern accepted discretionary authority to make those decisions he also accepted the responsibility the Allied officers had for compliance with Rule 14D-9 . . . .[125]

It was Kern's *choice* to accept responsibility for disclosure which required him to disclose the merger negotiations. Once he assumed an obligation of a client[126] to disclose certain facts, the SEC claimed that he was required to disclose these facts in a timely manner.[127]

In *In re Fishbein*,[128] the OTS alleged that lawyers at Kaye, Scholer also failed to live up to their assumed disclosure obligations.[129] As the

121. Exchange Act Admin. Proc. File No. 3-6869 [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,342, at 89,580 (Nov. 14, 1988).

122. Id. at 89,580-82.

123. The SEC held that George Kern "caused" his client Allied Signal to violate § 14(d)(4) of the Securities Exchange Act of 1934 (the "Exchange Act") by advising Allied not to disclose negotiations for the sale of a substantial amount of assets to a potential "white knight" when Allied was the subject of a tender offer. *See id.* at 89,589. The discussion herein of the *Kern* and Kaye, Scholer matters makes some of the same points as the discussion of these cases in Painter, *supra* note 97, at 293-95.

124. Except in very limited circumstances, a lawyer ordinarily should not disclose confidential client information without the client's consent. *See* Model Rule, *supra* 83, Rule 1.6.

125. *In re Kern*, at 89,592.

126. Section 12 of the Exchange Act as interpreted by Rule 12g-1, requires a company to register its shares with the SEC if (i) the company's stock is listed on a national exchange, or (ii) at the close of its fiscal year, the corporation had both a class of equity securities held by more than 500 shareholders and more than $5 million in assets. 15 U.S.C. § 78*l* (1995). Other provisions of the Exchange Act, including the tender offer rules, also apply to companies registered under Section 12. *Id.*

127. This holding was never reviewed by the SEC on the merits, as the proceeding was dismissed on jurisdictional grounds. *In re Kern*, at 89,585-86.

128. *See* Notice of Charges, *OTS v. Fishbein*, OTS AP-92-19 (Mar. 1, 1992) [hereinafter Notice of Charges].

129. Unlike SEC proceedings against lawyers, OTS actions have alleged that lawyers breached duties to their clients as well as to third parties. Harris Weinstein &

OTS' Acting Chief Counsel stated: "If a lawyer chooses to make statements of fact to an examiner in place of a client, as Peter Fishbein and Kaye, Scholer did in representing Lincoln Savings, then the lawyer is subject to the same disclosure requirements as the client."[130] Again, as Harris Weinstein, former Chief Counsel of the OTS, has pointed out: "[The Kaye, Scholer matter] was a case where the lawyers were alleged to have assumed an unusual responsibility for factual representations made to the regulators . . . ."[131] Kaye, Scholer thus assumed the "unusual responsibility" to make the same disclosures about Lincoln's operations which were required to be made by Lincoln.[132] Kaye, Scholer, according to the OTS, indicated its willingness to assume this responsibility by "demand[ing] that all FHLBB requests for information made in connection with the 1986 Examination be directed to . . . Kaye, Scholer" instead of to Lincoln.[133] Kaye, Scholer also chose to disclose facts to regulators in place of Lincoln.[134] Thus, "the OTS action asserted that Kaye, Scholer conducted the representation in a manner that resulted in Kaye, Scholer sponsoring or otherwise taking on its client's duties of disclosure. Kaye, Scholer then had to comply with those duties."[135] In the aftermath of Kaye, Scholer, even the ABA acknowledged that a lawyer may thus agree to assume a client's disclosure obligations:

Michael P. Socarras, Lincoln Savings and Loan: An Engine of Professional Liability 29-30 (Practicing Law Institute 1993). Also, some of the charges in Kaye, Scholer were not derived from the lawyers' assumed obligations. These charges include allegations that the lawyers themselves lied to regulators and that they represented Lincoln despite a known conflict of interest arising from Kaye, Scholer's representation of Lincoln's parent, American Continental Corporation. *See* Notice of Charges, *supra* note 128, at 25.

130. Carolyn B. Lieberman, *OTS's Position on Lawyer Ethics*, Wall St. J., Jan. 12, 1994, at A11.

> These enforcement actions were not brought because lawyers are required, either in the professional rules or by the OTS regulation, to volunteer information about a client. Rather, they are based on the principle that if a lawyer chooses to speak, or to sponsor a statement, the lawyer may not do so in a false or misleading manner, and he or she must counsel the client against doing so.

Carolyn B. Lieberman et al., *Professional Conduct in Representing a Regulated Industry: The OTS Experience*, 35 S. Tex. L. Rev. 607, 628 (1994) [hereinafter Lieberman, *Professional Conduct*].

131. Weinstein & Socarras, *supra* note 129, at 25.

132. Kaye, Scholer thus assumed Lincoln's obligation to maintain accurate and complete accounting and other records of all business transactions, Notice of Charges, *supra* note 128, at 20 (quoting 12 C.F.R. § 563.17-1(c) (1986)), was prohibited from knowingly making any false or misleading statements to the FHLBB or "omitting to state any material fact concerning any matter within the jurisdiction of the FHLBB," *id.* (citing 12 C.F.R. § 563.18(b)(1) (1986)), and was prohibited from "engaging in any dilatory, obstructionist, egregious, contemptuous, or unethical or improper professional conduct before the FHLBB." *Id.* (citing 12 C.F.R. § 513.4(a)(3)-(4) (1986)).

133. Notice of Charges, *supra* note 128, at 20.

134. *Id.*

135. Lieberman, *Professional Conduct*, *supra* note 130, at 629.

> [A] lawyer may put herself in a situation where she has assumed [such] obligations. When the lawyer is the only individual to deal directly with the bank examiners during the course of the examination, takes full responsibility for gathering factual information and preparing the client's submissions to the regulators, and cuts off the regulator from access the regulator otherwise might have to employees or the regulated entity, the lawyer may well have taken on the client's own obligation under the regulations to respond.[136]

Nonetheless, the responsibilities assumed by the lawyers at Kaye, Scholer, like those assumed by George Kern, and those read into the SEC's "contract" with the entire securities bar in *Carter & Johnson*, were ambiguous. Unlike the clearly defined rules of an enforced self regulation regime, these assumed responsibilities were inferred from conduct signalling that lawyers would be responsible for their clients' compliance efforts. Just as an implied-in-fact contract is more difficult to enforce than an explicit agreement,[137] however, implied understandings between regulators and lawyers do not provide clear guidance for lawyer conduct or for enforcement and disciplinary actions against lawyers. Professors Goetz and Scott observe that indeterminate signals are a dilemma in relational contracting generally, and that: "interpretive disputes will essentially be a lottery until the state provides the requisite instruments for more accurate signalling. To advance the normative objectives of contract law, courts must promote the evolution of predefined invocations that clearly trigger such

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136. ABA Comm. on Ethics and Professional Responsibility, Formal Op. 375 (1993) ("The Lawyer's Obligation to Disclose Information Adverse to the Client in the Context of a Bank Examination."); Lieberman, *Professional Conduct*, *supra* note 130, at 629.

137. *See* Pugh v. See's Candies, Inc., 171 Cal. Rptr. 917 (Cal. Ct. App. 1981); *see also* Foley v. Interactive Data Corp., 765 P.2d 373, 384-86 (Cal. 1988) (enforcing implied-in-fact contract that employee would not be dismissed except for cause). Courts have shown a "willingness to 'consider the entire relationship of the parties, and to find that facts and circumstances establish a contract which cannot be terminated by the employer without cause.'" *Foley*, 765 P.2d at 386 (quoting Alfred W. Blumrosen, *United States Report in Settlement of Disputes Concerning the Exercise of Employer Disciplinary Power*, 18 Rutgers L. Rev. 428, 432 (1964)). Although it is usually the employee subject to discipline who alleges an implied-in-fact contract covering discharge, these cases provide an interesting parallel to implied-in-fact understandings used by regulators to discipline lawyers. Indeed, difficulties of interpretation that arise when implied-in-fact terms are read into commercial and employment contracts are very similar to the problems of vagueness and enforceability that arise when regulators infer new lawyer undertakings from lawyer conduct. For a discussion of implied-in-fact contracts generally, see Ralph James Mooney, *The New Conceptualism in Contract Law*, 74 Or. L. Rev. 1131, 1171-87 (1995) (discussing judicial retreat from classic implied contract doctrine); Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 Cal. L. Rev. 261, 264-73 (1985) (discussing interaction between implied and express formulations and identifying errors which reduce contract reliability: i.e., formulation error, administrative error, ambiguity, incompleteness, inconsistency, interpretation error and ill-fitting formulations).

equitable resolutions of interpretational disputes."[138] This same problem of indeterminate signals and indefinite standards is endemic to the current state of relational contracting between lawyers and regulators.

An enforced self regulation regime in which lawyers and regulators clearly and precisely contract around regulatory defaults would be superior to this vague "quasi-contractual" regime with its inevitable misunderstandings between lawyers and regulators. Indeed, the indefinite standards that regulators read into lawyers' undertakings on behalf of clients have sparked substantial opposition from the organized bar.[139] This opposition is fueled by the fact that regulators equivocate at times,[140] and at other times impose harsh sanctions for breach of understandings *they* believe they have reached with lawyers.[141] Instead of urging lawyer participation in crafting precise contractual commitments with regulators, the bar has responded by adopting a very narrow vision of lawyers' role in client self regulation.[142] Regula-

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138. Goetz & Scott, *supra* note 137, at 320.

139. The legal profession has been staunchly resistant to efforts by regulators to impose higher responsibilities on lawyers in the regulatory arena, and has steadfastly resisted efforts by regulators to discipline attorneys. As early as 1975, the ABA stated that:

> Efforts by the government to impose responsibility upon lawyers to assure the quality of their clients' compliance with the law or to compel lawyers to give advice resolving all doubts in favor of regulatory restrictions would evoke serious and far-reaching disruption in the role of the lawyer as counselor, which would be detrimental to the public, clients and the legal profession.

Louis Loss, Fundamentals of Securities Regulation 1054 (1988) (quoting *ABA Report to the House of Delegates, Section on Corporation, Banking and Business Law Recommendation*, 31 Bus. Law. 544, 545 (1975)). Similar sentiments were expressed when the SEC conducted its proceedings in *Carter & Johnson* in 1981. *See* Stephen J. Friedman, *Reflections on Carter-Johnson*, Thirteenth Annual Institute On Securities Regulation 297 (Arthur Fleischer, Jr. et al. eds., 1982); Werner Kronstein, *The* Carter-Johnson *Case: A Higher Threshold for SEC Actions Against Lawyers*, 9 Sec. Reg. J. 293 (1981). The SEC was also criticized for its proceedings in *In re Kern* in the late 1980s. *See* Michael R. Klein, *SEC Reopens Old Wounds with its Proceeding Against George C. Kern, Jr.*, Insights, Sept. 1987, at 32. Most recently, the OTS was criticized in response to the Notice of Charges against Kaye, Scholer. *See* Don J. DeBenedictis, *The Big Freeze*, 78 A.B.A. J. 57 (1992); Amy Stevens & Paulette Thomas, *How a Big Law Firm Was Brought to Its Knees by Zealous Regulators*, Wall St. J., Mar. 13, 1992, at A1, A6.

140. SEC releases subsequent to the *Carter & Johnson* release have done much to confuse lawyers about the scope of a lawyer's affirmative obligations. As the SEC has pointed out, "[t]he Commission has not formally addressed the expansion or modification of the standard enunciated in *Carter and Johnson* and intends to take no further action in that regard. Since *Carter and Johnson*, the Commission has not attempted to set professional standards of conduct in Rule 2(e) proceedings, but has relied on a showing of violations of the securities laws." Adoption of Amendment to Rule 2(e)(7), Securities Act Release No. 6783 [1987-88 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,248, at 89,244 n.31 (July 7, 1988).

141. *See supra* notes 128-36 and accompanying text for a discussion of *In re Fishbein*.

142. *See supra* notes 80, 139.

tors are thus locked in an indefinite struggle with a recalcitrant bar, and the resulting stalemate continues to marginalize lawyers in the enforced self-regulation paradigm.

Lawyers and agencies also trust each other less when they struggle over vague rules and sporadic punishments. When agencies treat lawyers in a manner that lawyers perceive as unfair, this perception interferes with efforts to negotiate future standards, particularly if lawyers rebel against context-specific rules[143] that they perceive to be at the root of unpredictable regulatory standards. As lawyers retreat to a more absolutist and less context-specific view of their own responsibilities,[144] their perception of what is fair will harden in future dialogue with agencies over rules of professional conduct.[145] Absent a change in attitude on the part of both regulators and lawyers, Ayres and Braithwaite were perhaps correct to devote very little of their text to the role of lawyers in an enforced self regulation paradigm.[146]

3. Enforced Self Regulation of Lawyers

A true contractual regime, on the other hand, could facilitate explicit agreements between lawyers and regulators and thus substantially improve lawyers' roles in enforcing client self regulation. In an enforced self regulation regime, government agencies before which lawyers practice would allow individual lawyers, law firms, or bar associations, to devise their own rules of professional conduct to be approved by the regulators. These "tailored" rules would for the most part supplement existing rules of professional responsibility, although

143. *See* Wilkins, *Legal Realism for Lawyers*, *supra* note 16, at 485-86 (urging that context-specific rules replace traditional model's commitment to general, universally applicable ethical rules); Wilkins, *Regulating Lawyers After Kaye, Scholer*, *supra* note 16, at 1151-60 (same). The context-specific rules suggested by Wilkins can be a useful contribution of regulatory agencies to the regulation of lawyers. It is important, however, that these rules are not applied on an ad hoc basis *ex post*, but instead are clearly established *ex ante*.

144. *See supra* notes 80, 139.

145. As Professor Kreps notes:

> [R]etrospection is probably a crucial element to bargaining. What a player believes is just or fair or his due and what is due his rivals in a bargaining situation is likely to be very important in determining the outcome of a particular negotiation. And such notions are apt to be determined by past experiences, precedents, and the like.

Kreps, Game Theory, *supra* note 4, at 153.

146. Instead, Ayres and Braithwaite envision a tripartite regime where public interest groups have a critical role in avoiding industry capture of regulators and policing industry compliance. Ayres & Braithwaite, *supra* note 21, at 54-100. This Article explores ways in which the bar can be such a public interest group. Agency lawyers have a responsibility to represent the public interest. Firm lawyers, although they represent their clients rather than the public interest, still perform many of the functions of public interest groups if they encourage client compliance with both the letter and spirit of regulation. *See* David Dana, *Environmental Lawyers and the Public Service Model of Lawyering*, 74 Or. L. Rev. 57 (1995) (discussing client service and public service models of lawyering and the impediments to public service lawyering).

in some cases lawyers would be allowed to "contract out of" rules of professional responsibility that unduly narrow their responsibility to participate in a client's self regulation regime.[147] Regulators would determine what rules should be required of all lawyers practicing before their agency (i.e., prohibiting lawyers from misrepresenting facts or forwarding misleading documents to the regulators). Beyond this minimum standard, rules requiring a higher standard of lawyer diligence or disclosure would result in lawyers getting favorable regulatory treatment for their clients.

In an enforced self regulation regime, regulatory defaults could be set as majoritarian rules—rules that are appropriate for a majority of lawyers practicing before a particular agency—or as penalty default rules—more stringent default rules designed to encourage lawyers to negotiate their own tailor-made rules with the agency.[148] Alternatively, in circumstances where tailor made rules might be too confusing or idiosyncratic, regulators could design different sets of default rules for lawyers to choose between.[149] For example, rules could require a lawyer:

(1) to blow the whistle[150] or to make a "noisy withdrawal"[151] when a client is engaged in a crime or fraud;

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147. A good example would be Model Rule 1.6, prohibiting disclosure of client confidences and effectively precluding lawyer whistleblowing. *See* Painter, *supra* note 97, at 244 n.95.

148. Ayres & Braithwaite, *supra* note 21, at 108; Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules,* 99 Yale L.J. 87, 91-93 (1989) [hereinafter Ayres & Gertner, *Default Rules*]. A majoritarian rule might require that a lawyer resign in the face of client refusal to desist from egregious misconduct. A penalty default rule, on the other hand, might require that the lawyer disclose the misconduct to regulators.

149. *See* Ayres & Braithwaite, *supra* note 21, at 108-09. As Ayres and Braithwaite point out, corporate law in the United States allows corporate management and shareholders to choose between a variety of forms of corporate governance by choosing where to incorporate. *See* Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle,* 1 J. L. Econ. & Organization 225 (1985). I have suggested previously that lawyers be allowed to choose between a variety of rules of professional conduct concerning such controversial topics as whistleblowing by opting in to professional conduct rules used in another jurisdiction—for example, voluntarily agreeing to be bound by New Jersey's rule requiring lawyers to disclose client confidences if necessary to prevent a crime or fraud. *See* Painter, *supra* note 97, at 256-61.

150. *Id.* at 244-45; Richard W. Painter & Jennifer E. Duggan, *Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation,* 49 SMU L. Rev. (forthcoming 1996) (proposing default rules for lawyer disclosure of corporate fraud to independent directors and opt-in rules for disclosure to the SEC).

151. ABA Comm. on Ethics and Professional Responsibility, Formal Op. 366 (1992) ("Withdrawal When a Lawyer's Services Will Otherwise be Used to Perpetrate a Fraud."); *see also* Model Rules, *supra* note 83, Rule 1.6, cmt. 16 ("Neither this Rule nor Rule 1.8(b) nor Rule 1.16(d) prevents the lawyer from giving notice of the fact of withdrawal, and the lawyer may also withdraw or disaffirm any opinion, document, affirmation, or the like."); Ronald D. Rotunda, *The Notice of Withdrawal and the New Model Rules of Professional Conduct: Blowing the Whistle and Raising the Red Flag,* 63 Or. L. Rev. 455, 483-84 (1984) (arguing that notice of withdrawal essentially amounts to disclosure and thus accomplishes indirectly an objective that earlier drafts

(2) to opine to regulators on a periodic basis that a client is in compliance with specified regulations;

(3) to share certain types of confidential client information with regulators (without otherwise waiving the attorney-client privilege);

(4) to consult with specialized co-counsel when certain technical issues arise; or

(5) to conduct due diligence under specified circumstances (for example, to inquire into the financial soundness of a thrift by communicating with the thrift's accountants and lawyers, before working on offering materials distributed to investors in a limited partnership of which the thrift or an affiliate is a general partner).[152]

Although regulators may refuse to deal with lawyers who decline to choose certain rules, in most circumstances regulators only need to know ahead of time what rules lawyers have chosen. In the game-theoretic context, lawyers who want to steer play between themselves and regulators, as well as between their clients and regulators, into a joint cooperation equilibrium may choose rules designed to assure regulators that they and their clients are cooperating.

Law firms already negotiate detailed consent agreements with the OTS in settlement of disputes over lawyer misconduct in representing insured depository institutions. These consent agreements typically require, among other things, that the law firm: (i) review the finances of new banking clients; (ii) enter into written agreements with banking clients concerning the scope of the law firm's engagement; (iii) have a partner with ten or more years of banking-law experience supervise preparation of legal opinions covering compliance with banking laws as well as have a second partner approve such opinions; (iv) monitor conflicts of interest; (v) implement procedures to ensure that each attorney assigned to a banking matter has sufficient expertise; and (vi) adopt other procedures that reduce the risk of future banking violations.[153] The SEC also has on occasion negotiated consent agreements requiring prospective measures to avoid future violations.[154] Although these consent agreements have been used to settle allegations about past lawyer misconduct, similar agreements could be

of Rule 1.6 by the Kutak Commission had sought to accomplish directly—allowing lawyers to disclose client confidences to prevent a crime or fraud).

152. *See* Schneyer, *Bar Corporatism*, *supra* note 19, at 656 ("The Model Rules are too vague and general to provide guidance on this issue."). The FDIC has asserted that lawyers have just such a duty. FDIC v. O'Melveny & Meyers, 969 F.2d 744, 749 (9th Cir. 1992), *rev'd*, 114 S. Ct. 2048 (1994).

153. Schneyer, *Bar Corporatism*, *supra* note 19, at 645 n.27 (citing *In re* Fishbein, OTS AP-92-24, ¶ 2-17 (Mar. 11, 1992) (Order to Cease and Desist for Affirmative Relief from Kaye, Scholer, Fierman, Hays & Handler)).

154. Schneyer, *Bar Corporatism*, *supra* note 19, at 649 n.43 (citing *In re* Keating, Muething & Klekamp, Exchange Act Release No. 15,982 [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,124, at 81,981 (July 2, 1979) (recounting that almost every member of the respondent law firm was aware of at least one of a client's securities law violations; the consent agreement required the respondent law firm to adopt pro-

negotiated *ex ante* by regulators and law firms seeking favorable regulatory treatment of their clients.[155]

Furthermore, there has already been some negotiation of professional standards *ex ante* between agencies and groups representing lawyers in particular practice areas. Professor Schneyer points out several examples of what he calls "bar corporatism," or the "development of standards for a particular field of law practice through bilateral negotiations or dialogue between an ABA entity and an interested government agency."[156] Two specific examples Schneyer mentions are negotiation between the ABA Taxation Section and the Treasury Department of standards for "negative" tax opinions (opinions which decline to opine that tax benefits from an investment are more likely than not to be allowed),[157] and unilateral development by the ABA of a Third Party Legal Opinion Report which was later incorporated by federal banking regulators into consent decrees with individual lawyers and firms.[158]

Outside of the consent decree context, however, regulators have not engaged in bilateral negotiation of tailored standards with individual lawyers or law firms. Regulators instead rely on either applicable rules of professional conduct from state disciplinary authorities, rules or statutes imposed on lawyers in a particular practice area, or occasionally rules negotiated with the ABA or other bar associations. The one exception is when regulators presume that certain lawyers "assumed" clients' disclosure obligations, precisely the type of implied understanding that has caused great misunderstanding between lawyers and regulators. Otherwise, the same rules are presumed to apply to all lawyers, or at least to all lawyers in a particular practice area, without regard for the amount of responsibility individual lawyers want to assume or their clients are willing to pay them to assume.

One disadvantage of this "one rule for all lawyers" approach is that a single rule will not maximize regulatory compliance in the context of

cedures that would ensure that future securities filings would include all material facts about a client known to any one member of the firm)).

155. For a discussion of problems with enforcing agreements negotiated *ex ante* by agencies and firms, see *infra* notes 185-86 and accompanying text.

156. Schneyer, *Bar Corporatism*, *supra* note 19, at 658.

157. *Id.* at 657. Although the Treasury initially sought to ban such opinions, the negotiated compromise permitted negative opinions provided the lawyer has a reasonable basis to believe that tax benefits will be allowed and the negative conclusions are prominently noted in the opinion. *Id.* These standards were incorporated into both the ABA Committee on Ethics and Professional Responsibility Formal Opinion 346 (1982) and Treasury regulations making these guidelines enforceable in IRS disciplinary proceedings. *Id.* at 657-58 & nn.74 & 76 (citing Tax Shelter Opinions, 49 Fed. Reg. 6719, 7116 (1984) (codified at 31 C.F.R. §§ 10.33. 10.51(j), 10.52 and 10.76 (1994)).

158. Schneyer, *Bar Corporatism*, *supra* note 19, at 658 & n.77; *see also* Painter, supra note 97, at 227 & nn. 19 & 20 (discussing the ABA Third Party Legal Opinion Report).

all lawyer-client relationships.[159] Moreover, lawyers may ignore a rule imposed on them if they would have rejected the rule in bilateral negotiations with regulators.[160] If regulators cannot predict which lawyers will obey the rule, compliance is unlikely to be rewarded, making enforcement depend upon detection and punishment of lawyers who break the rule. Finally, immutable rules can be very unclear when drafted in circumstances where different constituencies that participate in the rule-making process cannot agree on the proper scope of a lawyer's responsibilities. The result may be convoluted language that reflects search for compromise rather than clarity,[161] as well as different rules in different jurisdictions.[162] Regulators may in turn disagree

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159. For example, the banking system would not necessarily be more secure if all lawyers representing insured depository institutions were bound to blow the whistle on client misconduct. Some lawyers would learn less about client misconduct and thus have fewer opportunities to take remedial measures under the mandatory whistleblowing rule. In the context of other lawyer-client relationships, however, a whistleblowing rule would not seriously impair lawyer access to information and would encourage client compliance. Painter, *supra* note 97, at 255-56.

160. *See id.* at 249-51.

161. Perhaps a good example is the disagreement among the drafters of the American Law Institute ("ALI") Restatement of the Law Governing Lawyers ("the Restatement") on lawyer whistleblowing. Section 117A of the draft Restatement permits disclosure to prevent death or serious bodily injury. The extent of disagreement within the ALI, however, as within other bar associations, on lawyer whistleblowing is best revealed by the two versions of § 117A(1)(b) that permit disclosure if a client has committed or intends to commit a crime or fraud which threatens to cause substantial financial loss. The Chief Reporter and others preferred permitting disclosure necessary to prevent the loss following a good faith attempt to dissuade the client from committing the crime or fraud. The alternative version, preferred by the ALI Director upon consultation with a four-person ad hoc subcommittee of the ALI Council, only permits disclosure of a crime or fraud "in the commission of which the lawyer's services were or are being employed." ALI Proposed Final Draft, § 117A. As the Reporters point out, the Section "[does] not apply to a past act of a client, no matter how clearly illegal and serious, if all of the harmful consequences of the act have already occurred," *id.* at cmt. a, and nowhere does § 117 require disclosure by the lawyer to prevent death, serious bodily injury or financial loss. Apart from the circumstances described in §117, the ALI Preliminary Draft allows a lawyer to disclose confidential client information only when a client consents (§ 114), when other law so requires (§ 115), when reasonably necessary in the lawyer's self defense of a malpractice or other action (§ 116), or in a dispute over the lawyer's compensation (§ 117). *See id.*

162. Rules on disclosure of client confidences are perhaps a good example. *See supra* note 92. Many state supreme courts have rewritten Model Rule 1.6 to allow or even require whistleblowing in a broader range of circumstances, and the disarray in the rules on this subject can be confusing for a practicing attorney. As Harris Weinstein, the former Chief Counsel of the OTS, has pointed out:

> If you are in Wilmington, Delaware, confronted by a client's intended fraudulent conduct that will likely cause substantial financial harm, and you practice law also in Pennsylvania and New Jersey, you are subject to three different rules. New Jersey requires disclosure to the proper authorities. Delaware forbids disclosure. Pennsylvania permits but does not require disclosure.

Harris Weinstein, *Attorney Liability in the Savings and Loan Crisis*, 1993 U. Ill. L. Rev. 53, 64 (1993); *see also* Del. Rules of Professional Responsibility Rule 1.6 (1983) sharply with the bar's interpretation of chosen rules and courts may refuse to definitively resolve this disagreement.[163]

By contrast, lawyers and regulators have less at stake in default rules and are likely to value clarity in such rules over content, knowing that they can probably contract around a rule they dislike. The tailor-made rules that lawyers and agencies agree to substitute for default rules also should be clearer and easier to follow than immutable rules. This clarity alone is a substantial benefit to those lawyers, perhaps a majority of lawyers, who are not as concerned about the rules' substance as they are concerned about knowing what the rules are.

Thus, although regulators have often advocated lawyer gatekeeping, there is considerable controversy over whether mandated lawyer

(following Model Rule 1.6); N.J. Rules of Professional Conduct Rule 1.6(b)(1) (1992) (requiring a lawyer to disclose information necessary to prevent a client "from committing a criminal, illegal or fraudulent act that the lawyer reasonably believes is likely to result in death or substantial bodily harm or substantial injury to the financial interest or property of another."); Pa. Rules of Professional Conduct Rule 1.6(c)(1) (1992). Although many states follow Pennsylvania in making disclosure optional, Florida follows New Jersey in requiring disclosure. *See* Fla. Rules of Professional Conduct Rule 1.6(b)(1) (1987).

To complicate matters further, the comment to Rule 1.16 allows a lawyer to withdraw from a representation and then suggest, but not fully disclose, to third parties the reasons for the withdrawal. *See* Model Rules, *supra* note 83, Rule 1.16 cmt. 3; Rotunda, *supra* note 151.

163. *See* Susan P. Koniak, *When Courts Refuse to Frame the Law and Others Frame It to Their Will*, 66 S. Cal. L. Rev. 1075, 1079-91 (1993). Under the securities laws, for example, some courts hold that attorneys have a duty to disclose before allowing a sale of securities or a merger to go forward. *See* SEC v. Frank, 388 F.2d 486, 489 (2d Cir. 1968) (involving an attorney enjoined against future violations of Section 10(b) after misrepresentations discovered in offering circular drafted in part by attorney); *see also* SEC v. National Student Mktg. Corp., 457 F. Supp. 682, 713 (D.D.C. 1978) (holding that an attorney should not close merger transaction if aware of changes to financial statements not disclosed to the shareholders who approved the merger). "Their silence was not only a breach of this duty to speak, but in addition lent the appearance of legitimacy to the closing." *Id.* at 713 (citation omitted). Although the Court was less clear on what the lawyers actually were obligated to say, "it is unnecessary to determine the precise extent of their obligations here, since . . . they took no steps whatsoever to delay the closing." *Id.* Professor Kraakman observes that the *National Student Marketing* court "seemingly adopted a protest duty," which would raise the costs of wrongdoing, but stop short of preventing misconduct. Reinier H. Kraakman, *Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy*, 2 J. L. Econ. & Org. 53, 59 n.11. (1986). Other courts hold that lawyers have a duty to disclose only to their clients. *See, e.g.*, Renovitch v. Kaufman, 905 F.2d 1040, 1048 (7th Cir. 1990) (finding that attorney was not liable under 10(b) to investors in client's fraudulent cattle leasing program because no duty to disclose); Abell v. Potomac Ins. Co., 858 F.2d 1104, 1124 (5th Cir. 1988) (holding that bond underwriter's counsel had no duty to plaintiff purchasers of bonds which could form the basis for liability under Section 10(b)); Barker v. Henderson, 797 F.2d 490, 497 (7th Cir. 1986) (holding that a law firm was not liable to purchasers of bonds for fraud under Section 10(b) of the Exchange Act because lawyer had no duty to disclose client issuer's fraud to purchasers of bonds); *see also* Painter, *supra* note 97, at 236-37 (recounting that some courts have held that attorneys have a duty to disclose fraud under the securities laws).

gatekeeping[164] is enforceable and cost effective.[165] Instead of insisting on uniform levels of lawyer gatekeeping or vague understandings with lawyers about how much lawyer gatekeeping will take place, the contractarian approach allows individual lawyers to specify to regulators the level of responsibility that the lawyers are willing to accept for a client's conduct. Regulators can "bargain" for enhanced lawyer responsibility by offering favorable regulatory treatment of lawyers' clients in return. Alternatively, regulators can insist that lawyers adopt certain minimal standards of professional conduct in order to practice before them. Regulators who strike this "bargain" may then insist that when lawyers assume an obligation to monitor or otherwise be responsible for a client's conduct, they should do so.

4. Sanctions in an Enforced Self-Regulation Regime

This enforced self-regulation regime, just like any other enforcement regime, is effective only if sanctions are imposed for breaches. Most regulatory agencies have procedures for disciplining attorneys,[166] although, with the exception of the SEC, rarely is this authority exercised.[167] Rule 2(e) proceedings by the SEC[168] are more common than proceedings by other administrative agencies,[169]

164. *See In re* Carter & Johnson, Exchange Release No. 17,597 [1981 Transfer Binder], Fed. Sec. L. Rep. (CCH) ¶ 82,847, at 84,172 (Feb. 28, 1981); Notice of Charges, *supra* note 128.

165. *See* Joseph C. Daley & Roberta S. Karmel, *Attorneys' Responsibilities: Adversaries at the Bar of the SEC*, 24 Emory L.J. 747 (1975); Kraakman, *supra* note 163, at 60 ("Whistleblowing leaves all regulatory targets at the mercy of their private monitors" and creates "incentive[s] to withhold information from potential whistleblowers"). *But see* George H. Brown, *Financial Institution Lawyers as Quasi-Public Enforcers*, 7 Geo. J. Legal Ethics 637, 724 (1994) ("A mandatory disclosure system would significantly contribute to maintaining a safe and sound banking system, and it would help prevent a repeat of the rampant abuses uncovered during the past decade in the savings and loan industry.").

166. *See* Emerson, *supra* note 19, at 188 n.112 (citing rules permitting disbarment and other discipline of attorneys including: Civil Aeronautics Board, 14 C.F.R. § 300.20(a) (1990); Commodity Futures Trading Commission, 17 C.F.R. § 14.4-.9 (1990)).

167. "Of the many federal agencies with a disciplinary rule, the SEC is virtually the only one that uses it routinely." Emerson, *supra* note 19, at 234; *see also id.* at 235-37 n.381 (citing examples of sporadic disciplinary action against attorneys by the Patent and Trademark Office, the ICC, the Department of the Treasury, the Immigration and Naturalization Service, the FTC, the International Claims Commission, the IRS, the Commodities Futures Trading Commission, the FCC, and the National Labor Relations Board).

168. Although SEC proceedings against attorneys have not been expressly authorized by Congress, the courts have not interfered with Rule 2(e) proceedings on the grounds that the SEC has no authority to discipline attorneys. *Id.* at 191 (citing *In re* Keating, Muething & Klekamp, 47 S.E.C. 95, 109-17 (1979) (Karmel, R.S., SEC Commissioner, dissenting)); Daley & Karmel, *supra* note 165, at 763.

169. Roughly 139 Rule 2(e) cases were reported as of 1991; these cases involved 147 individual lawyers and four law firms. Emerson, *supra* note 19, at 175. During the "peak years" of 1975-1977, 53 individual attorneys, 36% of the total, and three law firms, 75% of the total, were subject to such proceedings. *Id.* at 176. By contrast, only

although infrequent relative to the number of lawyers practicing securities law. Moreover, the *In re Carter & Johnson* proceeding was the last time the SEC used administrative proceedings to determine initially a securities lawyer's professional obligations,[170] and since *In re Carter & Johnson* the SEC has brought Rule 2(e) proceedings after attorneys have already been found to have violated the securities laws.[171] In implementing Rule 2(e), the SEC thus declines to address attorney conduct proactively by defining what exactly an attorney should do about a client's violation.

The SEC also may sanction attorneys pursuant to the Remedies Act under which it may:

> enter an order requiring [a person who has or is about to violate the securities laws], and any other person that is, was, or would be a cause of the violation, due to an act or omission the person knew or should have known would contribute to such violation, to cease and desist from committing or causing such violation and any future violation of the same provision, rule or regulation. . . .[172]

Although the SEC has occasionally used the Remedies Act against attorneys,[173] the statutory language requires a finding that the securities laws have been violated or are about to be violated to justify entering an order to cease and desist.[174] Thus, the provision does not

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26 lawyers were subjected to Rule 2(e) proceedings during the 1980s. *Id.* at 176-77. The decline in Rule 2(e) proceedings has been attributed to a number of factors, including a decline in enforcement budgets and a shifting of enforcement priorities under the Reagan and Bush administrations. *Id.* at 211-12.

170. *Id.* at 213. "With respect to attorneys, the Commission generally has not sought to develop or apply independent standards of professional conduct. . . . [T]he Commission, as a matter of policy, generally refrains from using its administrative forum to conduct *de novo* determinations of the professional obligations of attorneys." *SEC Final Rule on Rule 2(e) Proceedings*, 20 Sec. Reg. & L. Rep. 1120 (BNA) (July 15, 1988); *see also* Emerson, *supra* note 19, at 214 (describing the SEC as being in a "2(e) sleep").

171. Emerson, *supra* note 19, at 213 n.292 ("[I]t has been commission policy for the last seven years to only bring 2(e) proceedings against an attorney if he or she previously has been involved in another enforcement action." (comment of SEC General Counsel Daniel Goelzer at Commission meeting on July 7, 1988)); *SEC Final Rule on Rule 2(e) Proceedings*, *supra* note 170, at 1120-21 & n.31 ("Since *Carter and Johnson*, the Commission has not attempted to set professional standards of conduct in Rule 2(e) proceedings, but has relied on a showing of violation of the securities laws."). The SEC has also been very unclear regarding the standard of culpability required for a Rule 2(e) proceeding and appears to hold attorneys to a different standard—scienter—than accountants—negligence. *See* Painter & Duggan, *supra* note 150 (criticizing the SEC for imposing inconsistent standards on the legal and accounting professions without explaining why (*citing* Checkosky v. SEC, 23 F.2d 452 (D.C. Cir. 1994)).

172. 15 U.S.C. § 77h-1 (1994).

173. *See In re* Jeffrey Feldman, Securities Act Release No. 7014, 1993 LEXIS 2401 (Sept. 20, 1993) (involving a lawyer for three Pakistani banks who "aided and abetted and caused" violations of Sections 5(a) and (c) of the Securities Act when advising the banks that an offering of rupee-denominated foreign exchange bearer certificates did not involve securities required to be registered before sale in the United States).

174. 15 U.S.C. §§ 77h-1, 78u-3 (1994).

effectively address unprofessional as opposed to illegal conduct; an attorney can only be sanctioned after an underlying violation has been established and the attorney is found to have committed or to have been the "cause" of the violation.

Finally, Section 104 of the Private Securities Litigation Reform Act of 1995 amends Section 20 of the Exchange Act to expressly grant the Commission authority to prosecute persons who aid and abet violations of the securities laws:

> Prosecution of persons who aid and abet violations.
> For purposes of any action brought by the Commission under paragraph (1) or (3) of section 78(u)(d) of this title, any person that knowingly provides substantial assistance to another person in violation of a provision of this chapter, or of any rule or regulation issued under this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.[175]

This amendment merely reaffirms the SEC's long-held view that it has the authority to pursue aiders and abetters as well as primary violators, despite the Supreme Court's recent ruling in *Central Bank v. First Interstate Bank*[176] that private litigants may not assert aiding and abetting claims under the Exchange Act.[177] Although the SEC occasionally prosecutes aiders and abetters, an underlying violation of the securities laws is a predicate for any action against an alleged aider and abetter, and such actions against lawyers are relatively rare. Indeed, the most prominent case involving lawyers as aiders and abetters, *SEC v. National Student Marketing*,[178] was decided almost twenty years ago. For the most part, federal courts have been very reluctant to uphold claims against professionals for aiding and abetting violations of the securities laws.[179]

175. Act of Dec. 22, 1995, Pub. L. No. 104-67, 1995 U.S.C.C.A.N. (109 Stat.) 737, 757 (to be codified at 15 U.S.C. § 78t(f)).

176. 114 S. Ct. 1439, 1446 (1994) (stating that no indication exists that Congress intended to create a private cause of action for aiding and abetting under Section 10(b) of the Securities Exchange Act of 1934).

177. *See id.*

178. 457 F. Supp. 682, 715 (D.D.C. 1978) (finding that an attorney aided and abetted, in violation of Section 10(b) and Rule 10b-5, by closing merger transaction with knowledge that changes to financial statements were not disclosed to shareholders who had voted to approve the merger). "Their silence was not only a breach of this duty to speak, but in addition lent the appearance of legitimacy to the closing." *Id.* at 713 (citation omitted); *see also* SEC v. Frank, 388 F.2d 486, 493 (2d Cir. 1968) (reversing injunction against future violations of Section 10(b) after misrepresentations discovered in offering circular drafted in part by attorney). For an overview of attorney liability under the securities laws, see Robert J. Haft, Liability of Attorneys and Accountants for Securities Transactions (1991); Marc I. Steinberg, *Attorney Liability Under Securities Laws*, 45 Sw. L.J. 711 (1991); Marc I. Steinberg, *Attorney Liability for Client Fraud*, 1991 Colum. Bus. L. Rev. 1.

179. Much of the case law in this area was decided prior to Central Bank v. First Interstate Bank, 114 S. Ct. 1439 (1994), and assumed a private right of action for

Nonetheless, as sporadic as its rulings are, the SEC is probably the most active regulatory agency when it comes to articulating and enforcing standards for attorney conduct. By way of contrast, until recently banking regulators did little to define standards for a banking lawyer's professional responsibilities. Regulators' handling of the savings and loan debacle is perhaps a good illustration of what should not be done—apparent laxity toward both regulated institutions and their lawyers followed by multi-million dollar asset attachments once conduct becomes particularly egregious.[180]

Furthermore, banking regulators have been turned back by the courts when they seek to implement the type of "enforced self regulation" described by Ayres and Braithwaite. For example, an agency's attempt to enforce an agreement negotiated even with the principles in a savings bank, much less with its lawyers, was held to exceed the agency's authority. In *Wachtel v. OTS*,[181] Hickory Investments ("Hickory") owned a majority stake in Investors Federal Savings Bank (the "Bank"). When the individual petitioners together purchased all of Hickory's stock, Hickory filed a notice of change of control with the FHLBB as well as a debt application seeking approval of its plan to increase its stake in the Bank from 73 percent to 90 percent using borrowed funds. The FHLBB approved Hickory's change of control but conditioned its approval of the debt application on Hickory's agreement that it would maintain the net worth of the Bank in accord with regulations "'as now or hereinafter in effect'" and would "'infuse sufficient and additional equity capital to effect compliance with such requirement.'"[182] Hickory's board then passed two resolutions mirroring the language of the FHLBB approval notice.[183] When Hickory apparently breached this agreement, the OTS subsequently ordered petitioners to pay it $5.6 million, asserting that the written condition required them to maintain the net worth of the savings bank subsidiary. Petitioners sought review of this order and denied the existence of an enforceable agreement. They alternatively contended

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aiding and abetting a violation of the securities laws. *See* Renovitch v. Kaufman, 905 F.2d 1040, 1045 (7th Cir. 1990); Abell v. Potomac Ins. Co., 858 F.2d 1104 (5th Cir. 1988); Barker v. Henderson, 797 F.2d 490, 494 (7th Cir. 1986). In Schatz v. Rosenberg, 943 F.2d 485 (4th Cir. 1991), the Fourth Circuit held that where lawyers merely "paper[ed] the deal" and "act[ed] as a scrivener," they could not be held liable either for a direct violation of Section 10(b) or as an aider and abettor. *Id.* at 497.

180. *See* Macey & Miller, *supra* note 26, at 1132-39 (arguing that the OTS charged Kaye, Scholer in part to cover up its own ineptitude). Federal deposit insurance criteria used to evaluate the regulators themselves create "strong incentives for regulators to delay closing insolvent financial institutions. In fact, banking regulators have strong incentives to delay identifying problem banks, to deny the severity of the banking crisis generally, and to postpone meaningful action for as long as possible regardless of the cost." *Id.* at 1133.

181. 982 F.2d 581 (D.C. Cir. 1993).

182. *Id.* at 582-83 (quoting 12 C.F.R. § 536.13 (1995)).

183. *Id.* at 582.

that the underlying statute required the OTS to demonstrate either unjust enrichment or reckless disregard of legal obligations before it could impose such an order.[184] The D.C. Circuit sided with the petitioners, finding that the "OTS' efforts in this case to circumvent the statutory language strike us as attributable not so much to creative lawyering as to excessive zeal."[185] Judge Silberman, writing for the Court, stated:

> Perhaps the most vexing question that emerges is whether petitioners ever violated a "condition imposed in writing by the agency" or a "written agreement" with OTS—only then would OTS have authority under Section 1818(b)(1) to impose a cease and desist order of any kind. The parties argue extensively as to whether the various communications between OTS' predecessors and Hickory (or the individual petitioners) constitute written agreements or conditions within the meaning of the statute, or whether they should properly be thought of as more informal understandings. We do not have to decide this issue, however, because assuming, *arguendo*, that OTS' view on this matter (that the agreements to stipulate are conditions imposed in writing) is correct, we agree with petitioners that OTS

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184. *Id.* 12 U.S.C. § 1818(b)(1) provides in pertinent part:

> If . . . the agency has reasonable cause to believe that the depository institution or any institution-affiliated party . . . [is violating or has violated,] or the agency has reasonable cause to believe that the depository institution or any institution-affiliated party is about to violate, a law, rule, or regulation, *or any condition imposed in writing by the agency in connection with the granting of any application or other request by the depository institution or any written agreement entered into with the agency*, the agency may issue and serve upon the depository institution or such party a notice of charges in respect thereof . . . . [T]he agency may issue and serve upon the depository institution or the institution-affiliated party an order to cease and desist from any such violation or practice. Such order may, by provisions which may be mandatory or otherwise, require the depository institution or its institution-affiliated parties to cease and desist from the same, and, further, *to take affirmative action to correct the conditions* resulting from any such violation or practice.

12 U.S.C. § 1818(b)(1) (1994) (emphasis added). 12 U.S.C. § 1818(b)(6) provides in pertinent part:

> Affirmative action to correct conditions resulting from violations or practices. The authority to issue an order under this subsection and subsection (c) of this section which requires an insured depository institution or any institution-affiliated party to take affirmative action to correct or remedy any conditions resulting from any violation or practice with respect to which such order is issued includes the authority to require such depository institution or such party to—
>
> (A) *make restitution or provide reimbursement, indemnification, or guarantee against loss* if—
>
> (i) such depository institution or such party was unjustly enriched in connection with such violation or practice; or
>
> (ii) the violation or practice involved a reckless disregard for the law or any applicable regulations or prior order of the appropriate Federal banking agency.

12 U.S.C. § 1818(b)(6) (1994) (emphasis added).

185. *Wachtel*, 982 F.2d at 586.

> wholly lacked authority to issue the order directing petitioners to pay the government $5.3 million.[186]

In short, while the OTS can enter into written agreements with the managers and owners of a savings bank, enforcement of these agreements is constrained by immutable rules set forth in the underlying statutory scheme. Without enforceable agreements, however, an enforced self regulation regime, whether directed at depository institutions or their lawyers, is meaningless.

Indeed, throughout the 1980s and early 1990s, the OTS was even less successful at articulating clear and enforceable standards for attorney conduct than enforcing standards for depository institution conduct. In one of the most notorious cases of alleged attorney misconduct, the Kaye, Scholer law firm demonstrated its recalcitrance very early on in the Lincoln Savings matter (much of it stemming from the firm's failure to distinguish between conduct that was possibly appropriate in litigation and conduct that was appropriate in a bank examination).[187] The firm's recalcitrance with regulators should have triggered a reprimand from the FHLBB and, if Kaye, Scholer persisted, the FHLBB perhaps should have insisted that Lincoln hire another law firm or face increased regulatory scrutiny.[188] Such gradual

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186. *Id.* at 583-84.

187. Very early on in the representation, Peter Fishbein assumed an aggressive posture toward the FHLBB, condemning the "abusive and costly" policies of the FHLBB and insisting that the FHLBB make all future requests for information through Kaye, Scholer, a request that the FHLBB saw as a "fundamental misunderstanding of the examination process." Susan Beck & Michael Orey, *They Got What They Deserved*, Am. Law., May 1992, at 68, 70 (citation omitted), *cited in* W. Frank Newton, *A Lawyer's Duty to the Legal System and to a Client: Drawing the Line*, 35 S. Tex. L. Rev. 701, 703 (1994); *see also* Susan Beck, *Keating's Bouncer*, Am. Law. Jan.-Feb. 1990, at 40 (describing how Kaye, Scholer repeatedly threatened the FHLBB with lawsuits in order to deflect a regulatory crackdown on Lincoln).

There is no reason why federal regulators, particularly those regulating financial institutions in which the vast majority of deposits are insured by the federal government, should have to put up with a "lawyer as bouncer" mentality. In the private sector, there would be an immediate repercussion if an insured firm's lawyers were to treat a private insurance company like an unwelcome patron at a bar—for example, by refusing to allow the insurer on the premises for a safety inspection—cancellation of the insurance policy.

188. Prior to August 1995, the OTS used a "revised attorney letter," which the OTS required a depository institution to send to its counsel as part of a regular examination. In this letter the institution asked its lawyer to confirm that the attorney would respond in accordance with applicable rules of professional conduct to any issue that might arise in connection with conflicts of interest, the institution's compliance with laws or regulations, and fiduciary duties or principles of safety and soundness. The letter also provided that if the attorney did not provide the requested confirmations, the examiner would take this failure into account in its evaluation of the institution. *See* Lieberman, *Professional Conduct*, *supra* note 130, at 632-34; Revised Attorney Letter, OTS Transmittal No. 113, at 3 (June 24, 1994), *reprinted in* ABA Ad Hoc Committee on OTS Attorney Inquiry Letters, *Guidance for Lawyers Responding to the OTS Revised Attorney Letter*, 50 Bus. Law. 607, 629 (1995). Over two and one-half years, an ABA Ad Hoc Committee reviewed numerous drafts of the revised attorney

escalation of enforcement efforts was not the chosen strategy, however. Kaye, Scholer was not reprimanded or removed from the examination. As a result, the OTS found itself confronting alleged lawyer misconduct that it believed warranted extreme sanctions.

By contrast, Ayres and Braithwaite point out that an effectively enforced self-regulation regime makes a range of sanctions available either to deter misconduct, to incapacitate perpetrators of misconduct, or both, depending on which is appropriate.[189] Indeed, regulatory action should mostly occur at the "base" of an "enforcement pyramid"[190] with persuasion and occasional warning letters being the predominant response to relatively minor breaches.[191] Ayres and Braithwaite cogently argue that availability of high potency but rarely used maximum sanctions, the "benign big gun," at the top of the enforcement pyramid has a deterrent effect that pushes actual enforcement responses down to the base of the pyramid.[192]

Making such a range of sanctions available to regulators is critical to the effective regulation of lawyers as well as their clients. Many different levels of offenses are possible, but, if only a few different types of punishments are available, there may not be a politically acceptable means to punish the less serious offenses and punishments for the more serious offenses may not be severe enough.[193] For example, if regulators can only suspend or disbar lawyers from practice before their agency, offenses that do not merit such severe sanctions will most likely go unpunished. Availability of and willingness to use sanctions, such as a public reprimand or imposition of remedial measures on a law firm, thus can be critical to assuring that less serious offenses are addressed as well. Otherwise, these offenses may evolve into more serious offenses as the lawyers continue to disregard appropriate standards of professional conduct. At the other end of the spectrum, a regulatory agency may not be able to deter egregious lawyer conduct if the agency is not empowered to bring civil actions against lawyers for monetary damages.

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letter, met with OTS representatives, and discussed issues raised by the OTS drafts. Lieberman, *Professional Conduct*, *supra* note 130, at 631-33.

189. Ayres & Braithwaite, *supra* note 21, at 35.

190. *Id.* Ayres and Braithwaite adopt Braithwaite's original argument that an agency's enforcement efforts are most effective if the agency explicitly displays an enforcement pyramid with a variety of regulatory responses, from less severe responses at the bottom of the pyramid to more severe responses toward the top: persuasion, warning letters, civil penalties, criminal penalties, license suspension, and license revocation. *Id.;* John Braithwaite, To Punish or Persuade: Enforcement of Coal Mine Safety 182 (1985). Of course, different enforcement pyramids are appropriate for different regulatory contexts, such as health and safety, environmental, and banking regulation.

191. Ayres & Braithwaite, *supra* note 21, at 35-36.

192. *Id.* at 40-44.

193. *Id.* at 37.

Regulators are far more likely to be effective disciplinarians of lawyers if they impose milder and more predictable sanctions earlier in their relationship with recalcitrant lawyers. This more measured approach to lawyer discipline would in turn encourage lawyers to accept regulators' authority over the bar as well as over regulated firms. Mutual respect could eventually replace the current atmosphere of mutual recrimination.

CONCLUSION

This Article has examined the function of regulatory lawyers within two paradigms: a paradigm of "games" between regulators, regulated firms, and lawyers; and a paradigm that allows for contractual "bargaining" between these various players. Neither the game theoretic nor the contractual paradigm completely describes the relationship between lawyers and regulators. These two paradigms, however, provide a cohesive analysis of the actual, and especially of the potential, role of lawyers in the regulatory process.

Regulatory agencies have an opportunity to play rule-making and enforcement "games" with lawyers to encourage gatekeeping and discourage antisocial conduct. Regulatory agencies also have an opportunity to strike "bargains" with lawyers that will influence lawyers' behavior. Unfortunately, regulators have used relatively ineffective strategies for regulating the legal profession including: (i) relying on vague implied understandings that they believe they have arrived at with lawyers instead of actually negotiating with individual lawyers or groups of lawyers; (ii) starting at the top of the enforcement pyramid and relying too much on the occasional "big stick" to punish egregious defection instead of more measured responses to minor incidents; and (iii) failing to communicate to lawyers that lawyer choice of a cooperative strategy in lawyer/regulator games will be rewarded with favorable regulatory treatment of the lawyers' clients.

This Article suggests that regulators: (i) clearly signal their willingness to play cooperative "game" strategies with firm lawyers who will themselves play cooperative strategies and (ii) adopt a more coherent and explicit "contractarian" approach to the regulation of lawyers. Using the consent decrees that agencies currently negotiate with recalcitrant law firms as a model, regulators could initiate an enforced self regulation regime in which lawyers and regulators, before any misconduct occurs, negotiate specific standards for lawyer conduct. Although default rules in codes of professional responsibility could be supplemented by a few new rules imposed by regulators, most new rules governing lawyers should be negotiated by regulators and lawyers. These rules should be both explicit and understandable, with predictable sanctions for breach. Such rules can then be vigorously yet fairly enforced by regulators *ex post*.