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## Efficiency and Conspiracy: Conflicts of Interest, Anti-Nepotism Rules, and Separation Strategies

### Cover Page Footnote

Brokaw Professor and Albert Clark Tate, Jr. Research Professor, University of Virginia School of Law. This Essay is a somewhat expanded version of the Robert L. Levine Distinguished Lecture delivered at Fordham University School of Law in October 1997. I am grateful for the hospitality and intellectual atmosphere surrounding that occasion. I am also indebted to Kyle Logue, Steve Croley, and Julie Roin, and to colleagues at the University of Toronto Faculty of Law for lively discussion on another version of this paper.

## ESSAY

# EFFICIENCY AND CONSPIRACY: CONFLICTS OF INTEREST, ANTI- NEPOTISM RULES, AND SEPARATION STRATEGIES

*Saul Levmore\**

### I. CONFLICTS AND SEPARATION SOLUTIONS

**W**ITHIN commuting distance of the headquarters of the three American manufacturers of automobiles is the National Motor Vehicle Emissions Laboratory. This facility, a part of the Environmental Protection Agency, checks different car models for conformity with national standards and for accurate disclosures regarding gas mileage and emissions. But my focus is not on what it does but rather on where it is situated. Its location in Ann Arbor, Michigan, might seem either surprising or reasonable to different observers. It might be sensible, or efficient, to place a monitoring agency near some of the organizations it supervises or regulates because a variety of transaction costs might be reduced through proximity. In this particular instance, the EPA might be able to attract engineers with valuable human capital acquired in the auto industry and it might be advantaged in the market for entry-level technicians or engineers who expected to benefit from their EPA experiences and then seek work in private industry. The Michigan location may also be beneficial if the labor force sought by the EPA tends to gravitate in the direction of communities populated by residents with similar skills or perhaps tastes, to the extent that tastes are linked to training and skills. It is possible that a substantial number of the EPA employees who work at this facility are married to engineers who work elsewhere in Michigan for the auto industry, if only because romantic attachments may have formed in engineering schools or around a set of skills and tastes. In any event, it is plausible that the government would find the skills it wants more expensive or more difficult to assemble elsewhere in the country. These potential benefits illustrate what is meant by "efficiency" in the title and text of the present Essay.

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Imagine, however, the reaction a Toyota executive might have upon learning of the testing center's location and contemplating perhaps an unfavorable report the EPA issues concerning a Toyota import. The testers in Michigan might have conflicts of interest and be inclined to structure tests or even find results which favor their friends and neighbors in the U.S. auto industry. There is something of a conflict by virtue of being U.S. citizens, because as taxpayers and citizens we benefit when our auto-makers are advantaged. There is more of a conflict because of the Michigan connection, and then still more to the extent that they are neighbors or relatives of those directly affected by U.S. auto companies' expansions and layoffs. We might think of these conflicts as presenting problems of fairness, or simply as threatening inefficiencies because of biased regulation. In the extreme case, our foreign competitors might think there is something of a conspiracy among our institutions and players.

This pattern is ubiquitous and nearly inevitable. In most situations familiarity or closeness of one kind or another offers the potential for efficiency gains but also for costly biases. Distancing or separating a decisionmaker from a subject will normally provide a degree of neutrality at the cost of requiring the decisionmaker to invest in information. Customs, private practice, and legal rules sometimes reflect just such a "separation strategy." We do not expect a prize or scholarship committee to make an award to the spouse or child of a committee member, most surgeons refrain from operating on their own children, and we require judges to recuse themselves from matters in which they have a direct interest—even though these decisionmakers are often best informed about the very subjects or beneficiaries they are inclined or required to avoid.<sup>1</sup> On the other hand, our practices and rules sometimes tolerate or even exploit informational advantages at the risk of unwanted bias. In private markets, supervisors evaluate the employees they know best despite the danger of unequal emotional attachments. As a customary matter, teachers and peers often select among applicants they know, in a manner that eschews anonymous decisionmaking, when bestowing a variety of rewards. Somewhat similarly, appeals court judges are aware of the identities not only of the parties before them but also of the lower court judges whose work they review. In these cases, additional anonymity would come at a cost far beyond the obvious administrative costs. In some sense much of the structure of our democratic system with its "checks and balances" reflects the idea that decisionmaking ought not to be separated from those it affects. And in a narrower context, legislators vote as a matter of course on questions affecting their home states and campaign donors.

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1. *See, e.g.*, 28 U.S.C. § 455(a) (1994) ("Any justice [or] judge . . . of the United States shall disqualify himself in any proceeding in which his impartiality might reasonably be questioned."); Model Code of Judicial Conduct, Canon 3, § E (1990).

In most of these cases, the tradeoff between neutrality and information is less stark than it first appears because there is further unbiased review on the part of courts, markets, or even through negotiation. If Toyota feels disadvantaged by a particular regulation, enforcement mechanism, or test result, it can complain to its government or ours and hope for some relief. It may also be possible to litigate in U.S. courts, although it may be difficult to carry whatever burden is put on it. Where courts are concerned, a complaint that points to some direct conflict of interest is likely to be taken seriously. Indeed, legal rules will sometimes explicitly call for judicial intervention where there are such conflicts.<sup>2</sup> A claim of an indirect conflict, such as that which may be associated with nationalistic fervor, preferences, or self interest, often seems of little use to a disappointed outsider, but in the long run such attacks on the integrity of a system may also lead to external review where neutrality can be purchased at the cost of educating the reviewer.

An outsider, such as Toyota, might also seek an alliance with domestic interests in the United States. Large numbers of consumers and employees in the United States are likely to be harmed whenever a foreign manufacturer is disadvantaged. Biased testing might lead to higher prices, less beneficial trade, or fewer jobs here with Toyota or ancillary enterprises, but the political advantage is likely to lie with domestic manufacturers.

One obvious opportunity for judicial intervention is where the conflict problem materializes in the form of an advocate or critical employee of a regulated company whose prior employment history has provided some inside information about the content or strategy of government regulation. There are well known rules restricting the ability of some persons who move from government service to the private sector from working on matters they participated in as public servants and from contacting or appearing before government officials who were once their colleagues.<sup>3</sup> But these rules constrain affected persons for a limited period of time, have little bearing on the problem of long-term regional, familial, or nationalistic loyalties, and do not even contemplate the problem of a private sector employee who moves to government service and is tempted to favor his friends in the private sector. This last source of conflicts would seem more significant than that arising out of mobility from the private to the public sector, but as will become clear, conflict-of-interest rules quite generally assume that one is loyal to one's present employer.

One can barely imagine a legal system, with much less separation between the judiciary and the executive branches, in which courts respond to concerns of bias against political or geographic outsiders by

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2. *See, e.g.*, 18 U.S.C. §§ 207, 216 (1994) (providing criminal and civil penalties against former governmental employees who engage in conflicted actions).

3. *See* 18 U.S.C. § 207 (1994).

shifting the burden of proof or subsidizing (or otherwise encouraging) independent inquiries. Thus, a court might respond to Toyota's hypothetical but easily imagined reaction to EPA testing results by shifting the burden of proof to the EPA to show that its tests were fair. Observers of corporate law recognize this strategy from that realm of American law where self-dealing of a kind is permitted, but is associated with a shift in the burden of proof such that the insider must demonstrate that the corporation received what it might have in an arm's length bargain.<sup>4</sup> Implicit disclosure requirements may also be present in the corporate fiduciary context—and that may be far more difficult to imagine in the case of government regulation—but I will set aside that aspect of conflicts and corporate law. I characterize this sort of judicial review as involving uncomfortably little in the way of separation of powers because courts would need to inspect a very large fraction of political or politically delegated decisionmaking. The boundary between politics and law would become yet more porous and shifting than it is at present.

A foreign producer who might have liked more judicial oversight of our administrative agencies might take some comfort in private oversight in the form of market mechanisms. These include private testers such as those employed by Consumer Reports and (in this case) magazines dedicated to the automobile industry. Even apart from the collective action problems associated with this and other markets for information, foreign competitors might well think that the problem of nationalistic bias extended to media coverage but that litigation against a magazine, for example, is probably a fruitless strategy. A more likely control on unfair testing and inefficiency is that some astonishing instances of biased testing might capture the attention of the non-specialized national media and backfire on favored domestic interests.

I do not mean to provide an exhaustive list of how conflicts in the regulatory process might develop or be controlled. The essential idea is that conflicts arise in part because the best-informed decisionmakers are also often persons likely to have some bias or conflict of interest. One method of controlling these conflicts is to appeal to occasional monitors whose distance and authority might not only facilitate some unbiased reviews but also whose potential intervention might encourage the better informed decisionmakers to control their biases in anticipation of occasional review. But all such schemes are costly. Indeed, the very presence of testing agencies or judicial review might be taken as evidence that occasional reviews through political and market forces are deemed unsatisfactory. Thus, the EPA's testing facility (setting aside its location) is itself a governmental and dis-

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4. See, e.g., *Cohen v. Ayers*, 596 F.2d 733, 739-40 (7th Cir. 1979); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 709-10 (Del. 1983). See generally Harry G. Henn & John R. Alexander, *Laws of Corporations* § 235 (3d ed. 1983).

tinctly nonmarket solution to an information problem.<sup>5</sup> Our government's involvement in this fashion is a fairly modest step away from pure self-reporting and markets; the growth of private testers and disseminators of information (as is common in the financial sector, for example) in lieu of governmental testing would have represented a truly nominal departure from self-reporting. An example of a radical solution would be for competing automobile manufacturers, or their governments, to ask Switzerland to conduct the tests and report the results. Even so, disappointed firms might still allege conspiracies, because a car maker could obviously try to influence a Swiss tester. It is likely, however, that distance, or separation, between subject and decisionmaker reduces conflicts and makes corruption easier to ferret out—albeit at the cost of developing duplicative expertise. This trade-off is at the root of debates about specialized agencies as opposed to more general courts. Other things being equal, we have come to expect that where regulation of an industry appears to require extensive technical expertise, specialized monitors will emerge. Where the costs of duplicative information gathering seem less prohibitive, courts of general jurisdiction are empowered.

This tradeoff between the costs and benefits of separation and, therefore, of conflicts of interest, is found everywhere. Virtually every allegation of misbehavior reminds us that outsiders might be more objective and might be more inclined to conclude that an institution, such as a political entity, firm, or school, is ripe for oversight and change. On the other hand, insiders know more about the behavior and institutions in question and can usually investigate more efficiently. Even at the level of the firm and the family we experience this tradeoff between self-study and outside consultants whose evaluations are less informed and more expensive, but possibly more critical and objective. The distance offered by an outside evaluator is in virtually all contexts both good and bad.

One of the great advantages of an independent judiciary is that most citizens are comfortable with internal investigations of firms, employers, governments, military units and other entities when these are subject to some oversight of a procedural or even substantive character by an independent judiciary. On the other hand, an important development of the last twenty years or so has been the evolution of a consensus, fueled perhaps by particular examples and by public choice theory, that judges are not above the fray but are themselves ambi-

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5. In this case it is an information problem in the sense that an important aim of emissions and mileage data is accurate disclosure itself. Here, it is also the case that the problem is one of a conflict of interest which, as described earlier, comes about because decisionmaking is located in the hands of a party who is apt to be better informed than one who is likely to be more neutral.

tious, ideological, and so forth.<sup>6</sup> A perspective that regards it as virtually impossible to find sustained impartiality is likely to come to have greater respect for markets (which is to say dispersed decisionmaking) or simply deep cynicism. For the purposes of the present Essay, however, it is sufficient to observe the form of institutional solutions without expressing much in the way of normative views as to their value.

## II. LAWYERS AND CONFLICTS

Lawyers are trained to recognize conflicts of interest, and often to avoid them or at least to disclose their presence.<sup>7</sup> These instructions or customs respond to the tension just described between costs and benefits, and information and neutrality.

The bulk of thinking about lawyers' special problems with conflicts concerns client representation and conflicts between present clients or between a present and past client. Lawyers are also trained to think about immediate conflicts between their own interests and their clients' in structuring their own compensation.<sup>8</sup> Somewhat less attention appears to be paid to problems generated by the mobility of lawyers, but that is a good place to observe the costs of dodging conflicts and, ultimately, the notable posture taken by lawyers with respect to the tradeoff between the costs and benefits of separation.

Consider, for example, the fact that law firm associates move with remarkable fluidity from firm to firm, even where clients of the new firm and of the old firm are adversaries in ongoing matters. The conflict is at two levels. First, there is the danger that client interests will be compromised. The new employer can take steps to minimize problems. Some effort is required to ensure that a new lawyer does not work on a matter on which he or she represented conflicting interests in the past.<sup>9</sup> On the other hand, when there is simply an adversarial client lurking in the past, rather than a specific matter, nothing

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6. A good launching point toward this growing literature is Richard A. Posner, *What Do Judges and Justices Maximize? (The Same Thing Everybody Else Does)*, 3 Sup. Ct. Econ. Rev. 1 (1993).

7. See, e.g., Model Rules of Professional Conduct Rule 1.7 (1983) [hereinafter Model Rules]; Model Code of Professional Responsibility EC 5-15, 5-16 (1981).

8. Many of the problems that arise are linked to the norms barring a lawyer from entering into a business transaction with a client, acquiring an interest adverse to a client, or acquiring a proprietary interest in a matter conducted on behalf of a client (other than a "reasonable" contingent fee in a civil matter). See, e.g., Model Rules, *supra* note 7, Rule 1.8.

9. Generally speaking, the concern is with ongoing litigation in which a lawyer obtained confidential information, regarding a matter of current interest to the new firm, while working in another law firm which represented a party other than that represented by the new firm. When the problem is identified, the migrating, informed lawyer is kept clear of the case. Disqualification of the (new) law firm as a whole is sometimes a risk unless the former client consents (normally before the disqualified lawyer begins work at the new firm). For a discussion of the relevant Model Rules and various state rules, see Attorneys' Liability Assurance Society, 1997 ALAS Loss Prevention Manual 45-62. See also *Silver Chrysler Plymouth, Inc. v. Chrysler Motors*



is normally required in the way of screening—even though the same chronology might well be regarded as an expression of disloyalty to the client if it all occurred internally, in a single firm. Some firms might establish partitioning rules, or “firewalls,” so that lawyers within a firm do not discuss some matters with one another. It would not be surprising to learn, however, that clients were uncomfortable with some of the lateral mobility that takes place among firms. It is easy to imagine a professional rule barring a law firm from employing lawyers who had worked on (the “other side of”) matters currently occupying the firm, or even when the work done was on unrelated matters but for parties who are adversaries of a current client.

A second conflict, or loyalty, problem is internal to the profession and of interest to clients only in the effect of rules concerning the formation of human capital on costs and services. When lawyers move among firms, they take with them not only clients but also human capital that they acquired while on the payroll of the earlier firms or employers. Competing claims as to these clients present a familiar source of difficulty, and part of that difficulty derives from the law’s inclination to regard clients as being completely free to choose their own lawyers. Still, this problem is not unique to law, and it represents a social problem only to the extent that this question of allocating property rights may lead to an underinvestment in training or learning, or even an overinvestment in secrecy or other devices that might protect against the later danger of defection.

It is fair to say that lawyers have been most cautious about conflicts regarding ongoing matters. They have sometimes been insistent, for example, that a single lawyer not represent multiple clients where potential conflicts loom—even though efficiencies from joint representation are fairly obvious.<sup>10</sup> Lawyers have been fairly conservative (which is to say they have thought more about avoiding conflicts than about the efficiency gains from sharing a lawyer’s expertise) with respect to client interests and confidences associated with lateral mobility. Thus, law firms do not rent one another’s associates even when one firm in a given city has excess capacity and another finds itself swamped with work. In theory, the relevant professional rules and case law would permit something approaching permeable borders between law firms. Firms might share or maintain pools of associates, or simply hire much more than they do from a common pool or supplier of temporary lawyers,<sup>11</sup> but generally they do not staff in this manner.

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Corp., 518 F.2d 751, 753-55 (2d Cir. 1975) (discussing mobility of young lawyers and rules of disqualification).

10. I will defer for another effort any serious comparative analysis, but one route to thinking about the efficiencies of joint representation and counseling is through the observation that most other legal systems enable such economies of scale with much more permissive rules regulating lawyers.

11. See Vincent R. Johnson & Virginia Coyle, *On the Transformation of the Legal Profession: The Advent of Temporary Lawyering*, 66 Notre Dame L. Rev. 359 (1990).

Where ongoing matters and relationships are concerned, lawyers are so accustomed to the advantages of avoiding conflicts of interests—applying the classical fiduciary or trustee rule of refusing to “wear two hats,” and thus erring on the side of safety (reducing “costs”) rather than efficiency (generating “benefits”)—that it is perhaps more useful to pay closer attention to examples of fluidity and efficiency than to those reflecting caution.<sup>12</sup>

It is likely that lawyers in the aggregate have been less cautious with regard to problems associated with the mobility of human capital. Perhaps this is a good thing because in some markets, firms might otherwise have monopoly or opportunistic power over their associates.<sup>13</sup> A cynic might say instead that lawyers have done a good job of developing rules that benefit the legal profession at the expense of clients. Each of these viewpoints can accommodate a story about the increased involvement of lawyers in alternative dispute resolution mechanisms. The cynical story is that lawyers do not wish to be left out of a potential growth industry. And the optimistic, evolutionary tale is that lawyers and law schools have been part of the gradual emergence of a substitute to adjudication, such that paying clients can indeed benefit from the efficiency of nonduplicative information gathering. This is especially the case where opposing parties share the professional who resolves their dispute, rather than where the parties continue to hire their own representatives to present facts and arguments to a third-party arbitrator.

### III. COMPARING THE PUBLIC AND PRIVATE SECTORS MORE GENERALLY

The discussion thus far has suggested that lawyers' rules dealing with potential conflicts among clients (and between lawyers and their clients), as well as some of the rules constraining certain government employees from quickly capitalizing in the private sector on their public sector experiences, offer examples of ways in which the tradeoff between the advantages and disadvantages of a separation strategy is not so much confronted as avoided by focusing on the former (the

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12. One way to think about this is that lawyers do not like the idea of firewalls when contemporary matters are at issue, so that time is unavailable as a building material for these firewalls. A lawyer will not work for two adversaries at the same time, unless each matter is quite unrelated to the subject of their dispute, and the lawyer does not herself practice in the area of the dispute.

13. If lateral movement were forbidden, new lawyers might command higher salaries as compensation for the lock-in problem, but there are surely problems of opportunism where there are barriers to moving firms. We need not characterize these as efficiency or fairness problems in order to see that there are likely to be smaller human capital problems in situations where lawyers do adopt the classical fiduciary rule of avoiding potential conflicts. There is room to be surprised that custom, market pressures, and legal rules have permitted so much lateral movement of lawyers among law firms and to and from clients, while there is so little reliance on firewalls within firms where the lateral movement of client interests is at stake.

benefits of separation) rather than the latter. This caution comes at a cost. Ideally, the discussion should now turn to contrasting examples of private sector, non-lawyer arrangements where caution is thrown to the wind; unfortunately, there is something of an incomparability problem here because of the nature of both government activity and lawyering.

The problem of government employees favoring some private actors over others, and the legislative or populist inclination to reduce this risk by constraining government employees who move to the private sector, does bring to mind the private practice of firms' occasional insistence on noncompetition clauses with their employees. By and large, however, when competitors raid each other in the quest for talented employees, shareholders and competitors are not likely to be uncomfortable. Toyota's concern (in the opening example of this Essay) about EPA employees with personal and professional links to a U.S. auto-maker (or to the state of Michigan) would derive from some sense that although the EPA and a domestic manufacturer are in one sense adversaries, it is also possible that they might collude to the detriment of Toyota as well as the EPA's true principals. Analogously, any two competitors might collude to the detriment of a third. On the other hand, if (by way of illustration) United Airlines adopted a policy of not employing anyone who had a connection to Northwest Airlines during the preceding several years, we would more likely regard this as dangerously anticompetitive rather than as sensibly cautious. One caution story is that United may fear that the employee will retain allegiance to its competitor and may even have been sent over to gather information. Another is that United fears complaints from Delta, or another competitor, which might see the "sharing" of an employee as a sign of potential collusion, much as Toyota might be uncomfortable if it observes employees moving back and forth between a U.S. auto-maker and the EPA. But these possibilities, and any associated conspiracy theory developed by one of these players, seem rather remote. Much of this remoteness can be traced to the intuition that a better way to impress a potential employer is to demonstrate fidelity to one's present employer, rather than to suggest a quick willingness to be disloyal and corrupt on behalf of the future employer—who will then fear similar behavior, but at its expense, in the future.

Some readers will regard these public and private settings as entirely incomparable. By sketching a different puzzle and its apparent resolution, however, more comparability is revealed than first meets the eye. Indeed, there is reason to regard the settings as substantially alike. The federal conflict of interest statute is organized around the problem of a government employee who goes to the private sector and seeks to capitalize on knowledge or contacts acquired in recent

government service.<sup>14</sup> Mobility within the private sector is sometimes subject to noncompetition agreements which are analogous. These restrictions are normally thought of as controlling the ability of employees to capitalize on knowledge developed at the expense of a prior employer; they can also be understood as limiting the possibilities of collusion between former co-workers, one of whom now works at a competitor firm. But why does the government's concern seem limited to the case of a government employee who moves to the private sector when similar problems would seem present when a private sector employee moves into the government sector? After all, the new employee could remain loyal to the previous employer, or seek to benefit previous co-workers, and so forth. Most selfishly, a new government regulator might make decisions in the public sector with an eye toward making his or her own earlier decisions in the private sector appear wise.

One approach to this problem builds on the intuition that present employers are generally better at monitoring employees than are past employers. I will not pursue this suggestion here, in part because the statutes aimed at conflicts of interest seem concerned with an employee in the private sector who exploits contacts with friends who remain in the public sector—and the “present employer” of those friends should in theory have an easy time monitoring their contacts. On the other hand, it may well be that the legal remedies available to an employer who detects or fears misbehavior by an employee are superior to those available to an employer who detects comparable misbehavior by an ex-employee. Inasmuch as my interest here is with the difference between rules in the public and private sectors, my attention turns to a different explanation.

A clue to the asymmetry between incoming and outgoing government employees can be found in the analogous question of loyalties in the private sector. When an employee leaves firm *A* and goes to firm *B*, there is something of a (now familiar) puzzle to the extent that *B* gloats over its new “acquisition” while *A* is somewhat defensive about the employee's departure. Once again, there is the possibility or danger that the employee will be loyal or self-interested in a way that benefits the former employer. Inasmuch as *A* and *B* are free to bid for the employee's services, however, there is some reason to think that on average each employee (and especially those with important information) gravitates towards his or her highest valuing employer.<sup>15</sup>

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14. Compare 18 U.S.C. § 207 (1994) (restricting the ability of former government employees to work outside of government on matters in which these employees personally and substantially participated while in government service) with 18 U.S.C. § 208 (1997) (constraining acts by government employees affecting a personal financial interest).

15. There are complications here, including the fact that the employee has something of a monopoly in selling his or her own service, but the intuition is that on average we should expect comparable division of the gains from trade between em-

The allocation mechanism is highly imperfect because competing firms may have different abilities to guard against the appropriation of proprietary information and because there are some sunk costs or first-mover complications, but we should normally expect the market for the employee to function in a reasonably efficient and normal fashion. If so, it will be the case that when an employee moves from *A* to *B* there is a bigger pie to divide (between employer and employee) in *B* than in *A*. A reasonable conjecture is that if a firm and a mobile employee will somehow exploit another firm, then it is more likely that it is the employee and his or her present employer that will do so, rather than the employee and the past employer. Put somewhat differently, if employers can only imperfectly protect their intellectual property, so that there is some vulnerability to unauthorized transfers by present or past employees (and especially by mobile employees) to competitor firms, then some transfers to competitor firms might still occur, but employees on average will still be found in their highest valued uses or positions.

Consider now an employee who moves from firm *C* to the government or the other way around. The critical difference is that the government is often unable to bid freely for the employee's services because of civil service or other fixed pay scales. In this case, when an employee moves from the government to the new employer, *C*, there is no particular reason to think that *C* values the employee's services more than does the government, which was unable to match or exceed the offer of compensation from *C*. There are a number of ways to link this difference with the probability of collusion between *C* and the employee (against the other employer, which in this case is the government). The most straightforward argument is that when an employee with valuable information contemplates leaving firm *A* in order to go to *B*, in part because *B* will pay for the employee's special knowledge or contacts with regard to *A*, *A* can retain the employee with an offer of greater compensation. In contrast, the government often cannot do so, and therefore the problem of departure from the government is greater than it is in the private sector. The problem is also greater than it is for an employee who leaves firm *C* in order to go work in the government. In the latter case, once again, the private firm can pay to retain the employee. When dealing with an employee who contemplates departure, the only "disadvantaged" employer is the government—and it is in just this situation that the statutory structure imposes constraints.

This is not the place to make too much of this claim about a connection between inflexible compensation and the use of separation as a

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ployee and employer so that the employer who bids highest is indeed the highest valuing "user" of this employee.

strategy where conflicts of interest are concerned.<sup>16</sup> But it is, I think, a connection worth introducing, and it is one to which I return below.<sup>17</sup>

#### IV. EFFICIENCY IN THE PRIVATE SECTOR

I have hinted that lawyers are more inclined toward separation strategies than are other persons. The practices and legal rules found in the banking industry offer a convenient illustration of the pull of efficiency, as opposed to a focus on the costs of conflicts to the exclusion of their informational benefits. Consider a bank with multiple clients. A bank's trust department is of course constrained by a variety of legal rules when dealing with multiple trusts or with beneficiaries of one trust, but when a bank or a similar commercial entity is simply lending to borrowers, there are fewer legal and customary constraints despite the potential for serious conflicts. A law firm that services client *X* may wisely decline to handle any matter for client *Y* if *Y* is a competitor of *X*, or if *Y* and *X* are in litigation over some unrelated matter. The law firm's caution is likely to extend beyond that required by law or the profession's model rules and, indeed, *X* and *Y* will customarily avoid using a common firm except for highly specialized matters. One way to think about this caution is that the law firm is engaging in a kind of reverse search strategy, leaving itself available for future, profitable work on behalf of *X*. In contrast, such concerns need not occupy banks. Competitors *X* and *Y* might well gravitate to the same bank; they would certainly expect to have some common bondholders; and a bank would be most unlikely to turn away business from *Y* simply because it enjoyed *X*'s patronage.

Lawyers, who have fantasized about the fees they might enjoy if they could have multiple competitors as clients, have thought of the bank's next step. Not only will the bank develop expertise in dealing with *X* that is then useful in soliciting and maintaining *Y*, but also the bank may gain confidential information in its dealings with *X* that the bank can use to its own advantage in dealing with *Y*. Note that the bank probably cannot use this information to *X*'s direct disadvantage;

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16. One problem with this argument about inflexible compensation in government is that the separation strategy, or conflict of interest rules, with respect to outgoing government employees seems to have grown stronger over time while government pay scales seem no more inflexible than in the past. One response may be that the civil service scale now has more bite because the wedge between government and private salaries has grown. Government employees, for whom the conflicts rules apply, may now be less inclined to think that they will remain in their public sector positions for long so that they may be more willing to accept corrupt bargains with private industry. Note that cabinet members do not expect to stay for the long haul because they are political appointees; but we may never have worried about them too much because there is more monitoring by the political process and media.

17. See *infra* Conclusion. I hope to return to the topic in more systematic fashion on another occasion.

for example, it (probably) cannot arm *Y* with information useful in mounting an hostile takeover of *X*.<sup>18</sup> But equipped, for instance, with information about *X*'s financial difficulties, the bank may learn to call in loans from *Y* or, if *X*'s problems bode well for *Y*, to compete advantageously in the market by lending to *Y* at a lower interest than it otherwise would. Most courts simply will not regard this sort of behavior as objectionable.<sup>19</sup> This treatment seems less startling if compared not to a lawyer who contemplates simultaneous competing clients but rather a lawyer who in representing a client makes use of knowledge that had been accumulated while working for a prior client. Lawyers can obviously cite precedents on behalf of *Y* that they learned from doing research for *X*. They can also earn retainers from *Y* that are available only because of their proven results on behalf of *X*. The major differences between law and banking in this regard relate to the rules and attitudes about having competitors in one's portfolio of clients, and perhaps also to the sensibilities of clients who may for various reasons react negatively to sharing law firms with competitors but react indifferently to sharing the source of seemingly fungible capital. In any event, the opportunities for gains arising out of overlapping (or conflicting) but lawful and customary services are surely greater for banks than for law firms.

#### V. RETHINKING ANTI-NEPOTISM RULES AS A SEPARATION STRATEGY

Another means of contrasting or highlighting the approach to potential conflicts taken by lawyers and by legislation concerning the mobility of government employees is to consider the evolution of anti-nepotism rules and the interesting puzzles associated with these evolving norms. It may be useful to go back a few steps here before proceeding forward. Law has long offered an extreme solution to conflict problems in the form of a rigid separation of interests. If *T* serves as a trustee who manages an orphans' trust, *T* simply may not sell his own personally owned property to that trust at any price.<sup>20</sup> If *T* does so, the trust (or an agent of the state) may wait and see what develops and then force *T* to disgorge any gains gleaned from this forbidden transaction.<sup>21</sup> This classical trust rule, and the admonition not to "wear two hats," reflects what I have called a separation "solution" or dodge of the problem posed by conflicts of interest and the tradeoff

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18. See *Washington Steel Corp. v. TW Corp.*, 602 F.2d 594, 603-04 (3d Cir. 1979) (suggesting in dicta that disseminating confidential information of one client to an acquiring company might violate securities laws).

19. See, e.g., *id.* at 604 (holding that the use within a loan department of information obtained from one borrower in evaluating a loan to another borrower is not actionable).

20. See 2A Austin Wakeman Scott & William Franklin Fratcher, *The Law of Trusts* § 170.12, at 351 (4th ed. 1987).

21. See *id.* at 351-54.

between costs and benefits. The separation strategy avoids problems of exploitation, ignorance, confrontation, and so forth. It may be "inefficient" in that the trust may need or profit greatly from property or services that *T*, the fiduciary, is perhaps uniquely well situated to provide. We have already seen the use of this separation strategy in the context of lawyers dealing with clients and their adversaries and in that of employees who move from the public to private sector. The law denying any member of the President's immediate family from serving in the cabinet is another example of the separation approach.<sup>22</sup> While that example is of recent origin, it is the tip of an old and vanishing example of separation, which is to say the rise and decline of anti-nepotism rules.

A precommitment not to hire the spouse or child of a present employee comes of course with an efficiency cost. The spouse of a current employee may be an excellent person to hire because of individual characteristics or even as a general matter. The more global claim arises from the observation that the employer has more information about spouses and their families than about most applicants. Moreover, a failure to hire the second family member may in some circumstances cost the employer the valued services of the first.<sup>23</sup> On the other hand, an anti-nepotism norm may also produce gains because it may enable a principal to block an agent from hiring corrupt and incompetent employees.<sup>24</sup> However, the norm may be more costly the more there are other employers nearby.<sup>25</sup> These observations reflect, I think, widespread perceptions about nepotistic hiring or precommitments against such employment.

The case against anti-nepotism rules, however, is perhaps more subtle than previously recognized. Hiring that appears corrupt can in fact be socially and privately efficient. Consider, for example, an employee, *A*, perhaps a professor in some department of a university, who might leave the university unless his<sup>26</sup> spouse, *S*, is offered some

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22. 5 U.S.C. § 3110 (1994).

23. I will limit the discussion in the text to anti-nepotism rules with respect to hiring the relative of an already existing employee. Some problems are mitigated when family members are hired at the same time, where none enjoyed a preexisting relationship with the new employer. On the other hand, this sort of hiring may simply defer the questions associated with promotion and (future) compensation.

24. I put the source of gains this way because other benefits would seem to be available if the employer simply decided in a case-by-case manner whether to employ a particular applicant who was related to an existing employee.

25. In a single-employer town, to take the extreme case, the efficiency cost of anti-nepotism rules is greatest because many valuable employees will be lost to other locations where there are employment opportunities for spouses, for instance. On the other hand, the potential gain from anti-nepotism rules is also great because the value to the employee of having a spouse hired (suboptimally) by the employer is greater.

26. With this pronoun I refer of course to one explanation for the decline of anti-nepotism rules, namely that they discriminated against women because men had often been hired earlier. In the extreme case, an employer in a single-employer location that had discriminated against women might find an anti-nepotism rule blocking its



position in the same institution. Imagine that the position pays 100, that the expected value of the best applicant, *B*, to the university is 110, and that *S*'s expected value is 80. At first blush, there is something puzzling about the nepotism problem itself, although economists may be the only ones to perceive a puzzle. If markets work well, then *A* ought to be able to extract a salary for himself that reflects his value to the university. And if *A* has already bargained for such a salary, then what further bargaining power does *A* have?<sup>27</sup>

The key step, I think, is to see that *A* (and *S*) may value the job for *S* at a price that exceeds the cost to the employer. Imagine for instance that the university would pay *A* 32 more than it does at present. Imagine further that *S*'s next best employment opportunity pays 60,<sup>28</sup> that the gain to *A-S* from securing the university position is 40, while the opportunity cost to the university is only 30 because that is the margin by which *B* is preferred over *S*. Put differently, in this example *S* is hardly of zero value to the employer; it is simply the case that the "loss" from hiring *S* is less than the gain to *A-S*, who we can view as a single economic unit. And *A-S* would rather gain 40 than 32 (from holding out for a better salary for *A*) while the university would rather hire *S* (at a cost of 30) than raise *A*'s salary by 32. To complete the example we might assume that *B*'s next best opportunity is worth 99 to *B*, so that hiring *S* rather than *B* is socially efficient as well as privately explicable.

To be sure, the employment of *S* could be inefficient, reflecting other agency problems. *A*'s friends may be entrusted with filling the position *S* seeks, and these friends may value their relationship with *S* more than they value their employer's well-being.<sup>29</sup> Other pessimistic stories are available, but the point is that there may be an efficiency gain from doing something that will seem unfair and conspiratorial to others.

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ability to hire women. Note that legal challenges to anti-nepotism rules have sometimes succeeded, especially when an employer's rules have broadly excluded spouses (not just from supervising their own spouses) and when brought as Title VII disparate impact claims (rather than based on equal protection or even constitutional grounds, such as the right to marry). See generally Leonard Bierman & Cynthia D. Fisher, *Antinepotism Rules Applied to Spouses: Business and Legal Viewpoints*, 35 Labor L.J. 634 (1984); see also EEOC v. Rath Packing Co., 787 F.2d 318 (8th Cir. 1986) (finding the defendant unable to meet its burden of showing business necessity of its anti-spouse rule where 95% of its current employees were men).

27. One possibility, which I will not pursue here, is that *A* "succeeded" in an earlier negotiation and therefore realizes that the university's true reservation price might have been yet higher. Demands about collateral matters offer an opportunity to reopen the bargain. In a more perfect market, nothing stops *A* from reopening the question of his own direct compensation.

28. If we wish to keep careful track of social and private gains, we might assume that 50 reflects the next best opportunity for *S* in this location but that *A* and (perhaps) the employer lose something by *A*'s moving to another location.

29. Similarly, they may consider too heavily the gains that accrue to their part of their employer's business while *S*'s salary or impact may be felt elsewhere.

A stylized but critical feature of the present example is the assumption that the position sought by both *B* and *S* paid the fixed salary of 100. A good department chair, concerned here more with university finances than mere social efficiency, might have known to offer the position to *S* but at a salary of 93. A simpler story is that raising *A*'s salary might be more visible to various monitors and constituents than is the more hidden cost of employing *S* rather than *B* (at any salary above 93). If so, it becomes more likely that *S* is hired in a way that is not only insufficiently protective of the institution's overall budget but also against its interests and socially inefficient as well. In short, the point of a system-wide anti-nepotism rule might be to control agency problems.

The fixed or flexible quality of the salary sought by *S* brings us finally to something of a thematic or, dare I say, unifying claim. The more flexible the salary associated with the position sought by *S*, the more likely it is that if *S* gets the position, the agent who hires *S* has negotiated down the salary so as to gain from *S*'s desire for the position. Moreover, the less flexible the salary associated with *A*'s position, the more likely it is that if *S* gets the second position, then this nepotistic hire is socially efficient because *A* could have bargained for a higher salary for himself, or the agent could simply have satisfied *A* with a higher salary rather than with a position for *S*.

The preceding analysis leads to a prediction that anti-nepotism rules will be most useful where salaries are least flexible. Indeed, there is evidence for this proposition. Anti-nepotism rules are more common in the public sector than in the private sphere, and it is in the public sector that we find civil service pay scales and so forth. Law professors will be especially interested in the similar connection between schools with lock-step salaries and anti-nepotism norms. Harvard Law School, for example, was relatively late in having a married couple on its faculty—and it is also one of the few law schools to pay strictly according to a fixed scale based on a measure of seniority. Again, the intuition is that since a valued faculty member would be unable to extract more pay through higher salary, the pressure would be on spousal employment. This pressure might, in turn, lead to agency problems or simply to the kind of envy the lock-step system was designed to avoid.

### CONCLUSION

I have suggested a number of connections between separation strategies, which is to say the primary means of avoiding conflicts of interest, and inflexible compensation. A fairly complicated argument describes a logical chain linking anti-nepotism rules to inflexible salaries. This argument, in turn, reflects back to separation norms more

generally. I had suggested earlier<sup>30</sup> that the fixed character of, or upper limit on, government salaries may explain the puzzling asymmetry of conflict of interest rules affecting employees who move between the private and public sectors. Separation can thus be seen as a kind of substitute for negotiated compensation. In both the government and anti-nepotism contexts, separation accompanies non-negotiable compensation.

Another example of the link between separation and inflexible compensation may be found in the lawyer-client relationship. Lawyers are often on fixed fees whether based on hourly scales, retainers, or contingency fees. Renegotiation is unattractive or barred because the client might be seriously disadvantaged if the lawyer backs out of the case at an inopportune time. In this context it is perhaps unsurprising that lawyers may not gain from wearing two hats. The conflicted lawyer might be tempted to renegotiate unilaterally. And the second source of gain to the lawyer might be private and socially undesirable. Again, inflexibility—arising here for a novel reason—drives separation.

A second conclusion sets aside this link between caution (or separation) and inflexibility, and focuses on the possibility that the development of rather serious conflict of interest rules in the public sector is itself troubling. The trouble might be described as follows. Once upon a time, lawyers helped provide three alternatives, or sets of default rules, for those who engaged in joint ventures. Parties could enter into mere contracts with good faith requirements, expectancy damages, and so forth. A second option was to follow the statutory rules set out for corporations (and perhaps partnerships), in which case they would be bound by relatively low-level fiduciary obligations (in one or both directions) such that those who initiated conflicts of interest would bear the burden of proof to show fair terms of trade. And the third alternative was to label one's arrangement as governed by trust law, in which case two-hatted transactions were barred and subject to more intense scrutiny, such as strong-form tracing.<sup>31</sup> Lawyers, through their adoption of particular rules of professional conduct, placed themselves in this third regime, where a separation strategy is often required. Law schools offered comparable numbers of courses in all three. With time, however, joint venturers, and private parties quite generally, declined to choose the third regime. Serious business is rarely done in trust form and it is apparent that the efficiency costs of the third regime are simply too great for most people's tastes or anxieties regarding conflicts and conspiracies. Investors choose as a matter of course to allow their agents to commingle funds

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30. See *supra* Part III.

31. On the contrast between corporate and trust fiduciaries, compare Henn & Alexander, *supra* note 4, § 238, with Scott & Fratcher, *supra* note 20, § 170. See generally Tamar Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 795, 805-07 (1983).

where lawyers once thought commingling was dangerous. In turn, law schools and legal scholars have reacted to this diminished demand for trust law such that it occupies but a very small part of the curriculum and of law review articles.

It may therefore be anachronistic and self-centered for lawyers to draft responses to populist outcries about revolving doors by choosing the separation-style solution, which most other industries have rejected. The efficiency costs of this separation strategy may be hidden and easily underestimated. Moreover, lawyers and law professors in their own lives seem to have gravitated toward other behavioral norms—professors feel free to assign their own books in their own classes even though royalties appear to belong to the professor, and attorneys feel free to use frequent flyer miles earned through tickets paid for by their firms and their clients. To the extent that it is often sensible to import rules from the private sector to the public sector, where the former seems well-functioning, it would appear that the most appropriate imports are quite different from made-to-order public sector constructs.