

**Legal Barriers to Innovation
(REGULATION, Vol. 31, #3 (Fall 2008))**

Gillian Hadfield

**USC Center in Law, Economics and Organization
Research Paper No. C09-5
USC Legal Studies Research Paper No. 09-5**



**CENTER IN LAW, ECONOMICS
AND ORGANIZATION
RESEARCH PAPER SERIES and LEGAL
STUDIES RESEARCH PAPER SERIES**

University of Southern California Law School
Los Angeles, CA 90089-0071

*The bar's control over corporate legal markets
is growing more costly.*

Legal Barriers to Innovation

BY GILLIAN K. HADFIELD

USC Gould School of Law

Few commentators, outside of the practicing bar and the judiciary, find much to recommend the modern system of professional regulation of lawyers. Legal scholars concerned about access to justice have often been scathing about what they perceive as self-serving claims by the American Bar Association that legal regulation is in the public interest.

To date, the critiques have had little impact. In recent years, the ABA has renewed its commitment to the justifications for self-regulation — the need to protect client confidentiality, guard against conflicts of interest, protect the public from unauthorized practice, and maintain the independence of the legal profession — that have been so soundly rejected by legal scholars. Indeed, as recently as 2003, over objections from antitrust officials at the Federal Trade Commission and the Department of Justice, and from its own ABA Sections of Antitrust Law and Delivery of Legal Services, the ABA urged states to invigorate enforcement of unauthorized practice laws against non-lawyers on the basis of a definition of “the practice of law” that effectively covers everything lawyers now do. This is compelling evidence that the organized bar’s regulatory agenda is still set by a continued use of the rubric of consumer protection to justify rigorous protection of the legal-services monopoly held by lawyers.

In this article, I focus on a cost of the current regulatory model that has been largely overlooked, given the emphasis on the impact of regulation on pricing and availability — particularly in the personal services sector. This is the cost of stagnation in the underlying design and content of legal inputs — what it means to “do law.” For the clients that

make up the core of the legal market — corporate and other business entities — self-regulation stands as a tremendous barrier to innovation in legal markets and thus as a severe obstacle to the effort to develop legal mechanisms that meet the needs of a rapidly transforming, globally competitive economy.



Gillian K. Hadfield is the Kirtland Professor of Law, professor of economics, and director of the Southern California Innovation Project at the USC Gould School of Law.

This article is adapted from a longer essay that appeared recently in the Stanford Law Review.

THE POLITICAL AND ECONOMIC FUNCTIONS OF LAW

Beginning with the ABA's founding in 1878, the American legal profession has claimed fundamental authority over the regulation of the entire legal system. The rhetoric even at the ABA's founding is stirring and startling in this regard. In his address to the Second Annual Meeting at Saratoga Springs in August of 1879, one ABA founder, Edward J. Phelps (later ABA president for 1880–1881 and Kent Professor at Yale Law School from 1881 to his death in 1900), articulated in powerful terms the “special” status of the lawyer in American society, above politics and the state: “If the Constitution ... belongs to the judicial department to determine and to administer, then it is placed in the safe-keeping of the American bar.... Let us stand fast by the ark of our covenant.”

Phelps' ringing rhetoric no doubt still stirs the soul of many an attorney some 130 years later. It is a short distance from this overt appeal to the role of lawyers in the protection of American constitutional ideals to the preamble one often finds in modern bar association codes of conduct — the set of regulations governing the profession — such as this one from the New York Bar Association:

The continued existence of a free and democratic society depends upon recognition of the concept that justice is based upon the rule of law grounded in respect for the dignity of the individual and his capacity through

reason for enlightened self-government. Law so grounded makes justice possible, for only through such law does the dignity of the individual attain respect and protection. Without it, individual rights become subject to unrestrained power, respect for law is destroyed, and rational self-government is impossible.

Lawyers, as guardians of the Law, play a vital role in the preservation of society.

But we should distinguish two very different functions of the law. One is the democratic/political function to which Phelps and the New York bar appeal: protecting the architecture of democratic institutions, protecting individual rights, and regulating the balance of power to promote the goals of self-governance such as human dignity, autonomy, fairness, and well-being. The other is the role of law in supporting efficient market transactions: establishing real and intellectual property rights and facilitating contractual and organizational economic relationships in finance, innovation, production, and trade. In this latter function, law is more appropriately judged not by how well it promotes the normative democratic goals of equality, autonomy, dignity, and so on, but rather by how well it promotes economic activity and efficiency.

It is no longer tenable for the functions of a legal system to be all knotted into a common core of fundamental rights of a political, democratic, or constitutional character. In the remainder of this article, I describe how the regulatory struc-

MORGAN BALLARD



ture of legal markets presents a major obstacle to those markets' efficient adaptation to a rapidly changing, globally competitive market economy.

HEAVILY REGULATED MARKET

The market for corporate legal products and services is one of the most heavily regulated in the economy. What follows is a catalogue of the attributes regulated by the bar and the judiciary (what I jointly refer to as "the legal profession") with respect to the innovation, production, pricing, and delivery of goods and services in this market.

PRODUCT The legal profession first defines the scope of its regulatory authority: what counts as a legal product and hence is subject to control by the profession. This is done overtly through the definition of "the practice of law." Although most states have codified the definition, most statutes are relatively vague and determining what counts as "the practice of law" has largely been left to judges. Many courts resist the idea that there can be a clear definition.

The most common definitions go only a short distance from the explicitly circular by defining "the practice of law" as the provision of services that require legal knowledge, skill, judgment, or ability — i.e., what lawyers do. In the law-thick world in which modern corporations exist, the practice of law covers just about all structural features of how the corporation goes about its business.

PRODUCER The reason for defining "the practice of law" is to determine who can provide legal products and services. The profession controls entry into this market. If a product or service falls within "the practice of law" then, with few exceptions, only lawyers may be suppliers in the market. The judges who produce law for the market, in a collaborative enterprise with the lawyers who appear before them, must also be lawyers.

What is a lawyer? A person who has satisfied the requirements for admission to the bar established by the profession and, in a majority of states, who maintains active membership in the statewide mandatory bar association.

LAW SCHOOLS The profession's control over who may provide legal products and services extends beyond its guard post at the entrance to law firm offices. In every state but California, the profession requires that those who sit for the bar first complete a three-year law degree in a law school accredited by the ABA. Indeed, establishing some control over what constitutes a law degree was a primary goal for the ABA right from its founding.

Today, the ABA plays a substantial role in determining who is admitted to law school and what happens when they are there. Among the requirements imposed by the ABA are admissions criteria (requiring the LSAT or equivalent), advanced standing limits (limiting the credit that can be given for classes at non-ABA or foreign law schools), the number of hours that must be spent in classes physically taught at a law school (thus limiting the use of distance education methods, independent research, field placements, clinics without a classroom

component, and courses taken in other departments), the classes that must be taught by full-time faculty, the areas that must be covered by the curriculum, the criteria for evaluating the curriculum, and minimum bar passage rates.

The bar's explicit control over the content of the bar exam also plays a powerful role. It not only establishes what law schools must accomplish (through minimum bar passage rates required to maintain accreditation), but it also shapes students' beliefs about what they need to learn and hence demand from their law classes.

The profession thus has substantial control over the supply of people who may provide legal products and services. It determines what attributes are selected for (such as the specific skills needed for the LSAT) in determining the population of providers. It determines what methods and techniques are brought to bear on thinking about the potential problems that buyers of legal services might have and the solutions that "lawyers" offer.

MARKETS Because the profession regulates at the state level (although often on the basis of regulatory standards developed by the ABA), providers of legal products and services must be licensed in each state in which they seek to operate. This means that a lawyer admitted only in New York, for example, cannot do any of the things that constitute "the practice of law" in California: draft contracts, negotiate settlements, provide representation in court, engage in pre-trial activity such as taking depositions or reviewing documents, or give legal advice on behalf of clients in California.

In recent years, in recognition of the reality of national law firm practice and the multi-state presence of many corporate clients, the ABA has urged some relaxation of the requirement that individual lawyers be admitted to the bar in a state before providing services to clients in that state. The restrictions left in place by the fundamental scheme of state-by-state professional regulation, however, place substantial restrictions on the type of entities that can compete in the legal market and the legal products and services that might be delivered. Few markets in the modern economy operate under such restrictive limitations on interstate commerce.

LAW FIRMS For a long time, firms that provide legal products and services had to be organized exclusively as partnerships among lawyers. In recent years, most states have allowed lawyers to form limited liability corporations. Those corporations, however, must be fully owned and managed by lawyers. Lawyers may not share revenues ("fees") with non-lawyers. Corporations, other than those owned and managed exclusively by lawyers, are prohibited from providing legal services, even if all services to clients are in fact performed by lawyers employed by the corporation.

This places significant restraint on the way in which legal-product firms are financed. Law firms cannot seek public investment on the stock exchange. They cannot diversify through capital strategies. A "start-up," even one dreamt up by a lawyer, cannot seek angel investors or tap into venture capital networks to build the business.

Lawyers can be employed by a corporation to provide serv-

ices to that corporation only, and through this vehicle legal services can potentially be integrated with other business inputs. Lawyers employed by a corporation, however, generally cannot provide services to anyone other than the corporation, even by contract and consent.

CONTRACT TERMS The “core values” of the legal profession that the ABA claims are irretrievably threatened by allowing corporations other than those owned and managed exclusively by lawyers to practice law are independent legal judgment, protection of client confidences, undivided loyalty, and avoidance of conflicts of interest. From the perspective of the market structure for the legal products and services lawyers supply to business entities, these shibboleths of legal practice, however, amount to mandatory terms in the contracts between suppliers and purchasers.

Lawyers offering legal products and services must promise to reach judgments based exclusively on legal reasoning (“independence”) uninformed by inputs from other professionals such as accountants, business consultants, insurance agents, or public relations managers — unless lawyers have the final decision-making authority. This prohibits, for example, private practitioners from supplying precisely the kind of integrated legal analysis and subordination to ultimate business judgment that corporations assemble within their increasingly large in-house legal departments.

Lawyers offering legal products and services must include confidentiality provisions in their contracts with their clients. Clients can exclude those provisions, but only by invoking complex rules determined by the profession regarding adequate waiver or informed consent and who within a client corporation possesses authority to exclude confidentiality protections. (They may have special difficulty excluding the profession’s only significant exception to the confidentiality obligation in the business setting, which is that the lawyer may disclose client confidences if the lawyer needs to do so to protect his or her own interests.)

Lawyers must include what in other settings would be regarded as non-compete provisions in the contracts they offer, promising substantially to restrict the supply of their services to those with interests (here, profit-making interests) adverse to the purchaser. Exclusion of these terms is, as with confidentiality, complex and subject to subtle rules determined by the profession.

Last, also in the name of preventing conflicts of interest, lawyers must restrict the financial terms of their contracts with purchasers of legal products and services to exclude a wide variety of alternative compensation mechanisms: ancillary business deals or security arrangements that are negotiated under conventional competitive market norms; shared litigation costs or a proprietary interest in a cause of action except in a contingent fee arrangement; payment by a third party where the third party retains any capacity to influence the services provided. Those restrictions have been held to prevent, for example, a legal product in which an insurance company promises to cover the cost of any litigation arising from policy claims and to finance that offering by employing staff

attorneys subject to cost-control mechanisms such as audits, litigation guidelines, and pre-approval.

OBSTACLES TO INNOVATION

The complex of restrictions on legal products and services amounts to an extraordinary level of ex ante consumer protection regulation for corporations and other business entities. But corporations are as capable of assessing the quality and risks of legal services delivered through markets as they are of assessing the quality and risks associated with procuring the other business inputs on which they rely, such as accounting, investment banking, consulting, and engineering services. Moreover, many corporations employ in-house attorneys who act as their buying agents in the legal market, providing a high level of expertise in the capacity to analyze the costs and benefits of alternative legal products and services. This is hardly the setting in which concerns for the significant imbalances in bargaining power or information that animate conventional consumer protection regulation are present. And the values at stake in the market for business legal products and services are fundamentally profits, not political or democratic rights or values.

Lawyers, in their regulatory mode, overtly resist the idea that law is a “business” rather than a noble profession. In doing this, they hearken back to de Tocqueville’s notion that the legal profession is the American aristocracy and that (as summarized by Georgetown’s David Luban) “lawyers, like aristocrats, have a calling higher than mere bourgeois commercialism.” But while it is clear that there are functions that lawyers perform that go above and beyond the mundane provision of economic services, it is also clear that a great deal of legal work is, and should be appreciated as, economic activity that contributes to the effective functioning of a market economy.

The extensive regulation imposed on this market by the profession has substantial economic costs. Conventional economic critiques of this regulation focus on supply restriction and resulting increases in price from scarcity. Because of significant expansions in the number of seats available in law schools and the substantial growth in the sheer size of the American legal profession over the last several decades, however, supply restrictions are clearly not the fundamental cause of high prices and total costs for legal services. “Too few lawyers” is not the problem.

The far more significant effect of regulation on the market for corporate legal services is reduced innovation in legal products and services. Professional regulation of legal markets dampens, even extinguishes, the market creativity that drives the modern economy forward.

There are four major effects on innovation arising from professional regulation of legal markets:

TOP-DOWN STANDARDIZATION By defining the practice of law as the deployment of conventionally understood legal skills to resolve legal problems as distinct from accounting, strategy, finance, or other problems, and by setting out the hard-to-modify contractual terms on which legal services can be provided, professional regulation of law overtly restricts what a legal

provider can provide. Developing integrated legal products or services that would combine tax and accounting processes, for example, is effectively forestalled by a regulatory determination that non-lawyers may not participate if the boundaries between “law” and “not law” are not sharply demarcated. Conventional methods for delivering legal results reify what a legal product is and must be. Innovators of new methods are restricted to tinkering within this restricted space of possible products.

The mandatory terms imposed on contracts for legal services in the guise of protecting core values in the profession and the interests of clients also substantially inhibit market feedback on what clients value and how much they value it. For example, confidentiality protections are costly — perhaps significantly so if they restrict the capacity to integrate the provision of services with other professionals or to offer products through a corporation not exclusively owned and managed by lawyers. The benefits of confidentiality have to be traded off against its costs. In some settings, no doubt, some clients would prefer less confidentiality if it resulted in a less costly input. Such trade offs are best determined by the market, not the regulator/provider.

The substantial obstacle to innovative thinking that professional regulation poses stems from the exclusive focus on the means of delivering legal inputs to business ends (e.g., advice, document production, adversarial representation in litigation, regulatory and negotiation settings) rather than the ends themselves. Richard Susskind, a leading thinker on the impact of information technology on the practice of law, begins his influential book *The Future of Law* with a powerful anecdote that conveys this point:

It is said that one of the world’s leading manufacturers of electric power tools invites its new executives to attend an induction course, at the opening session of which they are urged to consider a slide projected onto a large wall screen. The image put before them is of a gleaming electric drill and the executives are asked if this is what the company sells.

The executives look uncertainly around one another and tend as a group to concede that, yes, this is indeed what the company sells. It seems like a safe bet. They are immediately challenged by the next slide, however, that of a photograph of a hole, neatly drilled in a wall.

“That is what we sell,” the trainers suggest.

The extensive professional regulation of legal markets effectively ensures that legal providers continue to focus on building better drills and not figuring out how to produce better holes at lower cost.

HOMOGENEITY What prevents legal innovators from challenging the professional definitions? Even if the legal profession tightly delimits the box that defines what a legal product is, it has always been understood that innovative problem-solving requires “outside the box” thinking. Innovators have long been imagined as disaffected or isolated iconoclasts tinkering away in the garage, on the periphery of the

markets that their inventions might transform. Where are the “garage guys” in law?

Professional regulation effectively blocks the inventive activities that might transform legal markets both directly and, probably more importantly, indirectly. Directly, professional regulation ensures that only those who have gone through extensive induction into the conventional practice of law may participate in legal markets and thus gain exposure to the types of problems that existing legal services are and are not solving. Professional regulation also severely restricts both the pool of talent on which the market can draw and the extent to which the market can offer products that accomplish the integrated goals of a client. Professional control also limits who can sell into the market the inventions they generate if the “invention” includes a service component and cannot be hived off in, for example, a piece of software. This regulatory structure is akin to requiring that anyone with Google’s “mission to make the world’s information universally accessible and useful” must first complete a degree in library science and maintain standing in the professional association of librarians before embarking on the mission — a requirement that surely would have hobbled the garage activities of Internet search innovators Sergey Brin and Larry Page.

The greater impact of professional regulation on the capacity for innovation in legal products or services, however, probably comes from an indirect obstacle. This is the homogeneity of the population of potential innovators, and thus the “idea pool” from which innovations can emerge. The idea that variation in a data set contributes to the capacity of statistical methods to reach more reliable estimates of the relationships among variables has long been understood. It is also accepted that variation in a gene pool contributes to the potential for adaptive mutations that improve biological fitness and that variation in the identity of those who make up social networks, in the form of loose ties, increases the likelihood of learning about a good job or business opportunity. Wikis, peer production, online networks, open-source software, and the explosion of other methods of facilitating collaboration among a highly diverse set of thinkers throw the uniformity of legal thinkers into sharp relief. Legal regulation is a poster child for the failure to harness the benefits of diversity.

The homogeneity of legal thinkers stems from multiple sources. Those who can supply into legal markets go through the same educational filter and study a largely homogenous curriculum taught with largely homogeneous methods. They must pass a standardized bar exam that is identical for all providers in a state, and sometimes across several states, and which looms large over even the elective curricular choices that law students have. In their day-to-day work environment, unless they are in-house at a corporation, they interact almost exclusively with other lawyers with the same credentials and professional understanding of what the job requires. When they do interact with other professionals (in accounting, finance, strategy, and so on) or with the business managers who are their clients, particularly in the high-billable-hour world, the nature of the interaction is highly focused on conventionally framed legal questions, and the opportunity for unplanned discussions

about seemingly unrelated issues is sharply curtailed. The extraordinary levels of confidentiality that characterize legal work mean that information exchanged about problems, solutions, and practices is highly restricted, limiting the potential for outsiders to bring fresh insights to long-standing frameworks. The limitations on diversity in the client pool imposed by conflict-of-interest rules ensure further homogeneity of perspective. Moving outside of law firms, the producers of law in courts — judges and the lawyers who appear before them — are also drawn from this homogenous pool.

Additionally, the ongoing 19th century emphasis in law schools on legal education as mastery of doctrine and appellate argument and the limited attention paid to developing competence in problem-solving, judgment under uncertainty, collaboration, client interaction, negotiation, and complex practice, leaves law graduates ill-prepared to participate directly in solving the complex legal problems faced by business clients. In response, law firms are organized on a tight hierarchy that keeps most beginning lawyers away from client interaction and strategic decision-making until well into their careers.

Added to the enormous burden of generating high billable hours in most corporate law firms, few lawyers early in their careers have much opportunity to lift their heads out of the mounds of parceled-out detail to which they are assigned. This further restricts the landscape available to potential upstarts in the profession.

The cliché often applied to the legal profession is the notion that “when all you have is a hammer, everything looks like a nail.” But this captures only a part of why the homogeneity of those who can supply legal products and services has resulted in such stagnation in the nature of legal products and services. Apparently when everyone has a hammer, nobody can even imagine a world without nails.

SCALE AND SCOPE ECONOMIES Innovation is not merely the discovery of new ideas; it is the scaling up of those ideas into implementable organizations, systems, products, equipment, and processes that generate economic value. Professional regulation of legal markets significantly restricts the capacity for scaling up new legal ideas by limiting the potential to exploit economies of scale and scope. Through extensive ongoing restriction on the capacity of legal providers to supply products or services to entities located outside of the state in which they are licensed, professional regulation of legal markets limits innovation to those that are supported by smaller markets.

Consider even a basic consumer product such as the standard-form simple wills, originally in hardcopy books and now packaged in software and online, delivered by entities such as Nolo Press. State bar associations challenged the sale of those products as unauthorized practice of law (UPL). Even though many states have exempted such products from the UPL restrictions, it is a state-by-state process, and the standards vary from state to state. Moreover, in order to stay on the right side of the UPL restrictions and state bar associations, Nolo Press products and similar products must be generic and not intended to tailor solutions to the unique “circumstances or objectives of another person.” More elaborate products that use, for

example, artificial intelligence mechanisms to tailor documents or route non-standard issues into online advisory services or “Chat with a lawyer now!” mechanisms are presumably beyond the pale.

Cisco Systems, for example, would face UPL limitations on commercializing an online mechanism it developed in-house for rationalizing and significantly reducing the cost of producing nondisclosure agreements if it attempted to integrate the blank forms with tailored solutions. Cisco’s online contract builder allows engineers and executives to produce their own nondisclosure agreements without interaction with a lawyer unless, in answering a series of questions, the transaction is flagged by the system as requiring a tailored evaluation; in that case, the system has a “trap door” that electronically routes the document and transaction to the legal department for more careful assessment and, if needed, specialized drafting. Cisco can do this in-house — and can support the level of investment required to produce this product on the basis of its own significant scale as a user. But what it cannot do is offer the product, including trap-door evaluation and specialization, to the worldwide market. That also means it is not cost-efficient to Cisco to invest in further innovations in the procedure that might be warranted.

The response of state bar associations to the outsourcing of legal services — whereby the preparation and review of documents is farmed out to out-of-state or out-of-country providers (India is a prime supplier) — demonstrates the impact of restricted scale on innovation in legal products. Opinions from state bar ethical committees make clear that those services may only be provided to a client through retention and personal supervision by a lawyer with a traditional client relationship. Non-lawyers or out-of-state lawyers can supply legal services to lawyers, but not directly to the market. This limits the scale of these operations to what can be channeled through conventional one-on-one lawyer-client relationships and the labor-intensive exercise of case-by-case judgment.

By defining legal practice as economic inputs that must include a large individual human capital component, professional regulation of legal markets inhibits, for example, the extension into legal markets of the large-scale information processing that underlies much of the revolution in the modern economy. Google and Wal-Mart both owe their success to innovations in massive data analysis that allow the production of better search results, marketing, retail product design, inventory, and logistics.

Much of legal advice consists in lawyerly predictions about legal outcomes: the likelihood that contract or patent language will be challenged or that it will effectively prevent certain conduct; the probability that a product or process will generate liability and a given level of damages; the expected value of additional effort spent on refining compliance systems or filing another motion.

Legal markets, however, use painfully little actual data to make those predictions, despite the fact that together clients, law firms, regulatory agencies, and courts have within their computer databases massive quantities of data about the factors that affect patent litigations or contract negotiations or

liability risks. Reaping the rewards from large-scale data analysis, however, requires access to a large market to sell the products of that analysis. By restricting legal judgments to those made by individual lawyers licensed in a local jurisdiction, however, professional regulation hobbles access to markets of that size and the economies of scale available in data analysis.

Professional regulation also inhibits exploitation of economies of scope through the development of crossover processes, procedures, structures, or products that serve the integrated business needs of clients. For example, accountants may, through their expertise in managing financial systems, have lower-cost access to solutions for the legal dimensions of financial systems such as tax and securities regulation. Organizational theorists may be in a position to design mechanisms more effectively to manage employers' legal obligations. Strategy consultants may be more likely to devise innovative methods of managing contractual relationships and achieving the goals of securing commitment and efficient adaptation to changing business environments. These economies of scope, however, are substantially limited by the requirement that only lawyers provide ultimate advice about meeting legal obligations, reducing the incentive of non-lawyer experts to invest in and exploit their knowledge.

Prohibition of fee-sharing or non-lawyer ownership of legal providers ensures that the only solutions produced in the market are those that are derived from primary legal expertise, making use of non-legal expertise only as outside consumers of accounting, organizational, or strategy advice. There is little incentive to invest in devising new products and processes that fall in the specialized overlaps of these fields.

RESTRICTIONS ON FINANCING Innovation in legal markets is also severely hampered by limitations on the capacity for innovators to finance their entrepreneurial efforts. The prohibition on the corporate practice of law effectively eliminates the basic mechanism used to fuel innovative activity in most markets.

Risks in legal innovation cannot be spread through the mechanisms essential to the modern economy: diversified portfolios, large-scale and liquid capital markets, and tailored financial instruments. Venture capitalists face little incentive to invest in new legal ideas and to network entrepreneurs who can take good ideas and convert them into scalable, commercially viable innovations. An expert in organization, for example, who sees a way of more effectively managing even the conventional law firm can only ever aspire to employee status, subject to supervision by lawyers, in the new entity he or she might create.

Legal innovation is largely restricted to the plowed-back profits and owner-manager mechanisms that financed companies in the late 19th century. That predates the modern corporation, which brought with it the separation of ownership and control and the explosion of stock markets and financial institutions that prompted significant economic growth in the first part of the 20th century. This hobbles producers of legal products and services with the triple weights of restricted expertise (lawyers are experts in law, not management), limited access to capital (the only assets are cash flow), and lack of

diversification (partners who leave profits in the firm see their investments rise and fall on the basis of the success of the one firm). Those weights limit not only the growth of legal businesses, they also stymie the potential for substantial innovation by ruling out innovations that require more sophisticated forms of financing.

Limitations on the permissible terms in compensation contracts also substantially restrict the capacity of legal innovation by reducing access to mechanisms that can generate needed economic incentives for collaborative production. Although bar associations have generally permitted law firms to include non-lawyer employees in compensation and pension plans that include a profit-sharing component, for example, the sharing of profits cannot be tied directly to fees collected in particular transactions or cases, or to the generation of new business. Thus the compensation mechanism cannot be tied to productivity of a particular non-lawyer employee.

Joint ventures between lawyers and non-lawyers are also heavily restricted in the mechanisms they can use to share fees, requiring separation in legal and non-legal service provision and application of the profession's regulation of legal markets to non-legal markets. The prohibition on contracts with lawyers that restrict post-employment access to markets or clients eliminates access to a standard contractual mechanism used to support the incentive to share trade secrets and invest in information assets in many industries.

Finally, because of bar restrictions on the financing of legal providers, there is no incentive for analysts to develop expertise in spotting important developments in legal products or business strategies, or for business schools to produce expertise in law firm management. There is no incentive for venture capitalists to nurture inventive ideas with legal application. But these are basic mechanisms by which the modern economy drives innovation and cost reduction in products and services.

CONCLUSION

Several years ago, I wrote a few papers, including one for *Regulation*, about the possibility of private production of commercial law, particularly contract and corporate governance law. I envisioned a mechanism that would develop improved systems, rules, and procedures through competitive incentives to figure out how to offer lower-cost and higher-quality management of contractual and corporate owner-manager relationships. The mechanisms this private market could produce, I imagined, could differ significantly from the legal systems we now use to govern corporate contracting and governance. Contracting mechanisms could, for example, combine multiple non-legal components (economic expertise, organizational expertise, and dispute-resolution expertise) with legal components, to support contractual commitment or generate appropriate managerial incentives.

Invariably in presenting this work to academic audiences, I met the economist's favorite riposte: if this is such a great idea, why isn't anybody doing it? I now believe that the significant obstacle lies in the continued regulation of legal markets by the profession. This professional regulation limits what may be offered as a legal product or service, homogenizes the pool of

potential innovators in terms of training and risk-orientation, prohibits the corporate practice of law, severely restricts the available financing for large-scale legal ventures, and constrains the capacity to exploit economies of scope and scale in developing better methods of producing what business clients ultimately need: holes in pieces of wood, not more elaborate drills. “PrivateContracting, Inc.” simply cannot exist under the current scheme of professional control over legal markets.

Whether PrivateContracting, Inc. would ever get off the ground if the restrictions were lifted I cannot say. That is an entrepreneurial question that only the market can answer. But there can be no question that the economic impact of professional regulation on innovation in legal products and services is extensive and growing more costly each year, as the pace of innovation, transformation, and globalization increases in most sectors of the economy.

Corporate clients have in recent years mounted significant efforts to reduce the costs of legal services with powerful general counsel moving more and more legal work in-house or offshore, deploying more technology to manage legal information, document production, and review, and experimenting with flat fees, task-based billing, auctions for legal work, billing audits, and more aggressive service contracts to rein in bills from outside counsel. But it is not enough to reduce the cost of combing through the millions of documents now routinely produced in large corporate litigation with “e-discovery” by developing software that can process the documents, or sending the documents to Indian or American contract lawyers for review at a low hourly rate.

Instead, the system that has demanded millions of documents to resolve a business dispute has to be opened to market pressure and subjected to innovative efforts to figure out how to get the cost of procedures in line with their value. Corporate clients would therefore be better served to focus on the root cause of increasingly unsupportable legal costs — the system of professional regulation — and the most significant effect of that system — the obstruction of legal innovation.

Achieving regulatory change will require major shifts in U.S. perspectives about what is at stake in the design of professional regulation of lawyers. The origins of American professional regulation in the vision of the lawyer as a fundamental guardian of the Constitution, democracy, and individual rights casts a long shadow not only over the regulatory justifications offered by the profession but also over the framework for regulatory authority itself. Challenges to the economics of legal regulation are rebuffed by appeals to the essential role of lawyers in defending democracy and the rule of law and the essential deference owed to the judicial branch to ensure separation of powers.

The political/democratic and economic spheres of the legal system are, however, distinct and should be recognized as such for the purposes of regulatory design. They have different goals, different market structures, and serve normatively distinct ends. For the latter, a vigorous market that delivers more effective and lower-cost legal inputs and channels market pressures into innovation, rather than spiraling hourly rates, should be the goal.

INTERNATIONAL PRESSURE While the American bar has successfully sloughed off calls for opening up legal markets in the past and the power of the ABA nationally makes the prospect for political change seem utopian, the wheels are already in motion elsewhere in the world to create a substantially new legal industry. Those global developments will increasingly apply pressure to reform the American legal industry.

In the fall of 2007, for instance, the United Kingdom adopted sweeping reforms of its already much more open legal markets. Under the reforms, there are few UPL limitations. When fully implemented in the next few years, there will be few restrictions on the way in which a legal provider is organized — corporations may offer legal services — or financed or managed — non-lawyers may start, fund, and operate businesses that provide legal goods and services. Legal businesses can be publicly traded. Lawyers may combine with non-lawyers — investment bankers, accountants, communications experts, strategy consultants, and so on — to provide integrated legal products.

There are multiple avenues of professional training and professional regulation in the UK. But all professional bodies are required to keep their regulatory functions separate from their trade association functions and are ultimately responsible to an overarching, publicly accountable regulatory body — the Legal Services Board — composed of a majority of lay people who have never been lawyers. The board’s membership is appointed by the Lord Chancellor, who is normally an elected member of Parliament serving as the secretary of state for Justice. As a cabinet member heading the Ministry of Justice, the Lord Chancellor is responsible for the operation and independence of the courts. There is thus a coherent and politically accountable locus for policymaking with respect to the functioning and effectiveness of the legal system as a whole.

Without a significant shift in the United States, the American legal profession is likely to grow increasingly out of step with the needs of a transformed global economy. American lawyers have long dominated in international legal circles, largely because of their greater orientation to problem solving and strategy in the provision of traditional legal services. Truly innovative lawyering for the new economy, however, needs a far less restrictive and myopic regulatory model. **R**

Readings

- “Delivering Legality on the Internet: Developing Principles for the Private Provision of Commercial Law,” by Gillian K. Hadfield. *American Law and Economics Review*, Vol. 6 (2004).
- “Do Judges Systematically Favor the Interests of the Legal Profession?” by Benjamin H. Barton. *Alabama Law Review*, Vol. 59 (2008).
- *End of Lawyers? Rethinking the Nature of Legal Services*, by Richard Susskind. Oxford University Press, 2008.
- *The Future of Law: Facing the Challenges of Information Technology*, by Richard Susskind. Oxford University Press, 1998.
- “The Price of Law: How the Market for Lawyers Distorts the Justice System,” by Gillian K. Hadfield. *Michigan Law Review*, Vol. 98 (2000).