

## Response to Comments: “Legal Infrastructure and the New Economy”

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I have already thrown a lot of words at presenting the argument of my paper<sup>1</sup> so I want only to respond briefly to some of the helpful comments offered by my commentators.

Roger Noll’s observations about the challenges of developing a more innovative and effective legal infrastructure than we now have are well-taken.<sup>2</sup> I share his view that reducing the barriers to competition in the provision of legal goods and services, while perhaps necessary to prompt real change, may not prove sufficient. As Oliver Goodenough also suggests, there are other potential economic obstacles (Professor Goodenough cites collective action problems and arms’ race type incentives<sup>3</sup>) to overcome.<sup>4</sup> I am probably an optimist in this regard, but perhaps not a “technological optimist” in the sense of believing that if clients demand it, it will come.

Professor Noll lays out three key economic obstacles to innovation: appropriability, knowledge base, and organizational readiness.<sup>5</sup> I share his view that appropriability is not likely to prove a

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<sup>1</sup> Gillian K. Hadfield, *Legal Infrastructure and the New Economy*, 8 ISJLP 1 (2012).

<sup>2</sup> See Roger G. Noll, *Impediments to Legal Innovation in Legal Infrastructure*, 8 ISJLP 60 (2012).

<sup>3</sup> I discuss these obstacles and others in an earlier paper addressing the reasons why legal markets can fail to be competitive. See Gillian K. Hadfield, *The Price of Law: How the Market for Lawyers Distorts the Justice System*, 98 MICH. L. REV. 953 (2000) [hereinafter Hadfield, *The Price of Law*].

<sup>4</sup> Oliver R. Goodenough, *Response to Gillian Hadfield’s Legal Infrastructure and the New Economy*, 8 ISJLP 70 (2012).

<sup>5</sup> Noll, *supra* note 2, at 62.

major problem for law, at least, no more so than in other knowledge-based industries where the limited supply of expertise and other factors helps to secure a return on new ideas. As for knowledge base, while I do emphasize the importance of interdisciplinary collaboration to help solve legal problems, I did not intend to suggest that there is no need to expand the knowledge base beyond existing ideas. Nor did I intend to suggest that there will not be problems that are unsolvable because of constraints akin to the infeasibility of creating a biologically viable pest-resistant tomato. I am not claiming that every problem firms in the new economy face can be solved at a reasonable cost. More fundamentally, I doubt that the existing knowledge base is sufficient—this knowledge base includes a very specific conceptualization of what it means to have, or solve, a legal problem in the first place. I appreciate that Professor Noll has not put my theory to the impossible test of articulating what specific innovations could emerge in a less restrictive environment. But I can imagine that the possibilities include systems of law that look very different from what we currently have. We currently have almost no existing knowledge base on which to build, for example, a completely alternative system of securing contractual commitments, one that did not involve agreements and potential litigation over breach.<sup>6</sup> And maybe we cannot get there. But I am only claiming that we cannot get there if we do not increase the capacity for such innovations to emerge.

Professor Noll's most important observation is about the limitations on collaborative innovation and hence the organizational readiness for innovation.<sup>7</sup> I agree that this too might account for the frustration experienced by general counsel in securing new thinking from outside counsel and for the growth of in-house legal departments in the past few decades. The argument here runs that outside firms lack an incentive to invest heavily in the detailed business and technological details of their clients because the client rather than the law firm will capture most of the benefits. It is simply too difficult to write the contract that rewards the outside firm for the creation of

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<sup>6</sup> I agree with Professor Goodenough that there are intriguing possibilities that harness the power of networking such as contract wikis. (Professor Goodenough is one of our legal innovators in practice, responsible for developing together with the LawLab at Harvard's Berkman Center for Internet and Society, a fully digital LLC platform.) Although he suggests my failure to sketch out these possibilities is a lack of boldness on my part, it is really just the implication—as Professor Noll notes—of the fact that “innovation is impossible to predict.” Noll, *supra* note 2, at 61.

<sup>7</sup> *Id.* at 67–69.

innovative solutions: the measurement and pricing of “success” in developing innovations is inherently difficult, maybe impossible. I agree that some of particularly specialized innovations may be difficult to produce via contract. By the same token, for a large enough company, there may be enough scale to justify the vertical integration into this kind of innovation.

But I also think that much of the innovation that is needed is not highly client-specific. The problem of excessive complexity and delay in contracting, for example, is fairly widespread. So too the problems of excessive risk aversion and lack of appreciation of the multiple business considerations that impact litigation strategy. Throughout much of law, the development of expertise in highly specific problems produces generalizable strategies and innovations.

Indeed, a key reason I have focused in this paper on the concept of infrastructure is because I think that the bulk of the problem of innovation is not specific to individual companies facing the Williamsonian question of contract versus vertical integration. The content of our legal infrastructure is, I have argued, largely a by-product of legal work—generated in the course of drafting laws, regulations, and contracts; resolving disputes and negotiating transactions; structuring organizations and relationships. This is where the contract templates, litigation practices, case opinions, regulatory models, and so on come from. A more open market, I’m arguing, would shift the composition of that infrastructure largely as a by-product of bringing a more heterogeneous set of skills and mindsets to bear on individual legal matters. This is really a dynamic claim rather than an individual make-or-buy claim. Suppose a group of graphic designers and lawyers join together to form a consulting company that offers a visualized approach to supply contracting that substantially reduces contractual delays, errors and costs.<sup>8</sup> The innovative contracts that result may be better than the alternative wordy documents conventional lawyers would draft. But because of the kinds of contracting-for-innovation problems Professor Noll emphasizes, they will still fall short of a first-best solution to meet the needs of the company’s clients. Nonetheless, these innovative contracts will enter the set of legal materials available in the future, providing some heterogeneity in the contract databases available to future lawyers. They might form the teaching materials in a new law school class or they might be carried over into the in-house department of the next company the general counsel works for, where

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<sup>8</sup> See, e.g., Gerlinde Berger-Walliser, Robert C. Bird & Helena Haapio, *Promoting Business Success Through Contract Visualization*, 17 J.L. BUS. ETHICS 55 (2011).

they are married with the specific industry or company knowledge that produces an even better solution. This is how I would expect innovation in law to come about.

Brian Cabrera's comment provides a much more detailed picture of what the world looks like from the client side in the new economy than my brief anecdotes and survey results can ever do.<sup>9</sup> This is the demand side of the market talking directly to the supply side about what it needs and what it's willing to pay for: "Too often," he says, "I am presented with an approach that answers the legal question but [] does not address the business problem."<sup>10</sup> He urges potential providers to consider "solving for the complete data set" rather than "the legal answer."<sup>11</sup> Reading the 10-K and the company website, he adds, is not enough to fix that shortcoming; he is looking for providers who are willing to invest in a deep understanding of his business and who have developed the capacity (personal and organizational) to think globally at the speed he is required to act.<sup>12</sup>

Professor Noll's economic analysis suggests that Mr. Cabrera's advice may go unheeded and fail to produce a response from the supply side of the market because of the economics of collaborative contracting. The providers Mr. Cabrera is talking to may struggle to see a return on the investment in the deep engagement with his company and his industry that he is suggesting they undertake. Even with reduced regulatory barriers and increased competition, the pull of the demand side may be insufficient to overcome the powerful economics of innovation.

I suspect, however, that even if we cannot get to the first-best solution, we are pretty far from even the second-best solutions that could be generated to Mr. Cabrera's legal needs. The comments by Professor Goodenough and Peter Kalis give me some reason to wonder about that.<sup>13</sup> Both are lawyers who are, or have been, in the business of providing legal services to companies like Mr. Cabrera's. And yet both express doubt that the problems I have articulated on

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<sup>9</sup> See Brian E. Cabrera, *The New Economy and its Implications for Legal Services: A High Tech Perspective*, 8 ISJLP 80 (2012).

<sup>10</sup> *Id.* at 87.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.* at 86.

<sup>13</sup> See Goodenough, *supra* note 4; Peter J. Kalis, *The Hadfield Tunnel: A Comment on Legal Infrastructure and the New Economy*, 8 ISJLP 91 (2012).

the client side in the new economy can really exist. Both Professor Goodenough and Mr. Kalis reason as follows: The market is competitive. Therefore any client who really wanted something different could get it. Therefore either I am wrong about my claim that there is a significant gap between what even large corporate clients are able to purchase in legal markets and what they need, or clients are (in Mr. Kalis' words<sup>14</sup>) just being "whiny."

There are three responses I want to make to the claim from outside providers, who are understandably perplexed (and, in Mr. Kalis's case, apparently fairly incensed) by the suggestion that they are not providing as much value as their clients need.<sup>15</sup>

First, both Professor Goodenough and Mr. Kalis assert that the market for legal services is competitive because providers experience it to be competitive. But the experience of competition is not the test for whether a market is competitive in the economic sense. Protected markets can be intensely "competitive:" suppliers will fight "tooth and nail" (in Professor Goodenough's words<sup>16</sup>) to gain access to supra-competitive profits. Competitive markets, in the economic sense, are defined by the conditions of competition—who can compete, in what organizational form, with what financing, with what kind of employees and partners, and with what limitations such as private information and transaction costs—not by the experience of competition. Moreover, the fact there are some competitors does not mean that a market is competitive in the economic sense; there are degrees of imperfect competition that can hamper the generation of cost-effective solutions and innovations.<sup>17</sup>

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<sup>14</sup> Kalis, *supra* note 13, at 103.

<sup>15</sup> I note a surprising tendency in lawyers' responses to my work to exaggerate my claims and hence make of them a straw target. The claim is not that today's lawyers provide no value; it is that the value is less than it could be and what clients are ideally looking for. (For other examples of exaggeration of my claims, see *supra* notes 18 and 21 and accompanying text.) Mr. Kalis also interprets my discussion of the frustration general counsel feel with trade regulations or contracting requirements as evidence that they (and I) think there should be no regulations or contract requirements. In what I take as an expression of pique, Mr. Kalis suggests that those who think what lawyers do is unnecessarily burdensome should draft their own contracts or let the CFO (or gardener) handle their next complex deal unaided. I do not find this response very productive of insight.

<sup>16</sup> Goodenough, *supra* note 4, at 74.

<sup>17</sup> See Hadfield, *The Price of Law*, *supra* note 3.

Second, neither Professor Goodenough nor Mr. Kalis engages with the majority of my argument, which is economic and theoretical in nature.<sup>18</sup> In this paper and in earlier work I have offered several reasons to think that the markets for legal inputs may fail to be competitive. The reasons include the complexity of law and how that limits the supply of potential suppliers, the difficulty consumers of law face in evaluating the quality of providers in the face of very noisy information about the causes of good and bad outcomes, and the sunk costs in legal relationships that make ex post switching expensive.<sup>19</sup> They include the obstacles to efficient contracting for innovation that Professor Noll discusses. And they include the regulatory barriers I explore in this paper and other work.<sup>20</sup> That economic analysis cannot be swept away with the report that providers find the market competitive.

Third, and perhaps most importantly, the lack of engagement with the fundamental economics here is one of the reasons I am doubtful that existing legal markets will be responsive to the needs of the new economy any time soon. The key complaint from clients is that their lawyers just don't "get" their business, that there is a "DNA gap" between outside lawyers and clients. I have attempted to provide a theoretical roadmap to what "getting" the business of the new economy might entail. The general counsel I spoke to and those

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<sup>18</sup> Mr. Kalis erroneously thinks that the fact that firms in the 1950s also could be described as innovative or that even Cisco has conventional supplier problems characteristic of the old economy engages with the analysis. Professor Goodenough points to the entertainment industry of twenty years ago (which is not actually that long before the takeoff that economists identify in the technology industry—I bought my first Mac over twenty-five years ago). But both misunderstand the nature of the argument. The new economy moniker is a catchall for describing the ways in which globalization and technology—particularly Web 2.0—have shifted economic organization and interaction. See Hadfield, *supra* note 1. The old/new economy does not consist of what I called the "prototypical" and "stylized" old/new economy firm. These are abstract analytical devices for grasping how the shift in economic organization due to globalization and the web have impacted the economic demand for law. I think I could not have been clearer about this. See *id.* at 12. Moreover, all of the characteristics I point to are expressed as changes, not absolute levels: *increased* boundary-crossing, *more* pervasive and complex transactions in information, and so on. The claim is not that prior to the transformations of the last few decades there were no businesses with any of these characteristics and now all firms are characterized exclusively by these characteristics.

<sup>19</sup> See Hadfield, *The Price of Law*, *supra* note 3.

<sup>20</sup> See Gillian K. Hadfield, *Legal Barriers to Innovation: The Growing Economic Cost of Professional Control over Corporate Legal Markets*, 60 STAN. L. REV. 1689 (2008).

surveyed by many others<sup>21</sup> are attempting to educate the provider market about what they would be willing to pay top dollar for. Brian Cabrera in his comment here takes pains to sketch out how a provider could win his business by solving his problems better. I am perplexed why the response is not: tell me more. I doubt that these client companies—Google, Synopsys, Cisco, Juniper Networks, Mozilla, CBS—would respond this way to feedback from their customer base, or to insights into the structural reasons why solutions they are now offering are not producing as much value as they could. I think that’s how competitive providers would—and should—respond.

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<sup>21</sup> Both Professor Goodenough and Mr. Kalis are wrong to say that my conclusions about the gaps between demand and supply are based on anecdotal evidence from five Silicon Valley general counsel. While I would think any provider would be interested in the views of the general counsel I spoke to—they are expert observers who are peering over the edge of the modern economy—these anecdotes are offered only as illustrations to make the data from other sources and my theoretical claims vivid. My claims are largely based in economic theory and observations about the attributes of current legal practice such as the reliance on craft-based production and densely worded documents. The empirical evidence I offer about the gaps as perceived by clients includes large-scale surveys of general counsel, such as those done by BTI, Altman Weil, researchers at Harvard Law School, and the Association of Corporate Counsel, as well as data about legal fees and costs. *See* Hadfield, *supra* note 1, at 31, n.60, 32–33 nn.65–66 (2012).