

# Formalizing Legal Reputation Markets

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## I. Introduction

A positive reputation yields advantages in a negotiation even before the first word is spoken. Therefore, a good reputation is one of the most valuable assets a negotiator can have. Studies have indicated that having a reputation for cooperative problem-solving (an “integrative reputation”)<sup>1</sup> in negotiation produces more efficient outcomes than having a reputation for competitive bargaining (a “distributional” reputation).<sup>2</sup> Having a distributive reputation induces the other side to keep information private, which minimizes the potential for mutually advantageous trades.<sup>3</sup> On the other hand, having an integrative reputation induces counterparties to be more open and share sensitive information, which produces superior economic outcomes.<sup>4</sup> Surveys of attorneys replicated these results. Attorneys with a more “problem-solving” orientation were seen as more effective by their peers, and attorneys with a more “adversarial” approach were seen as ineffective.<sup>5</sup> These data suggest that a negotiator’s reputation as an effective problem-solver allows him or her to achieve better substantive results and increased peer respect. Additionally, reputational effects on a negotiation are greater if they exist prior to a negotiation than if counterparties form reputational judgments during the course of

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<sup>1</sup> See Gary Goodpaster, *A Primer on Competitive Bargaining*, 1996 J. ON DISPUTE RESOLUTION 325, 327-28 (defining integrative bargaining).

<sup>2</sup> See, e.g., Catherine Tinsley et al., *Reputations in Negotiation*, in THE NEGOTIATOR’S FIELDBOOK 203, 206 (Andrea K. Schneider & Christopher Honeyman eds., 2007); Andrea K. Schneider, *Shattering Negotiation Myths: Empirical Evidence on the Effectiveness of Negotiation Style*, 7 HARV. NEGOT. L. REV. 143, 196 (“The myth of the effective hard bargainer should be destroyed.”); HOWARD RAIFFA ET AL., NEGOTIATION ANALYSIS: THE SCIENCE AND ART OF COLLABORATIVE DECISION MAKING 273-74 (2002) (describing studies of how parties forego leave gains from trade because of strategic behavior).

<sup>3</sup> Tinsley, *supra* note 2 at 206.

<sup>4</sup> *Id.* at 207.

<sup>5</sup> *Id.* at 208.

negotiations.<sup>6</sup> Therefore, it seems to be incumbent on negotiators to develop integrative reputations. I will begin this paper by briefly explaining the need for reputational information and why it is rarely supplied. Second, I will discuss the theoretical foundation for a reputation markets for lawyers. Finally, the majority of the paper will compare the advantages and disadvantages of two potential mechanisms for the provision of reputational information.

## **II. Reputational Information: Why We Need It and Why We Don't Have It**

A good reputation does not produce superior outcomes in and of itself. Rather, a good reputation encourages parties to exchange information by limiting the fear of exploitation. Information transfer, in turn, enables problem-solving negotiation behaviors by each party: sharing interests, presenting alternatives, and discussing priorities honestly.<sup>7</sup> Problem-solving negotiation then produces superior results for both parties.<sup>8</sup> Thus, reputational information enhances negotiation outcomes in two ways. First, accurate reputational information allows parties to pre-identify integrative negotiators, reduce the cost of establishing a reputation, avoid the possibility of mistaken identification, and actively seek other integrative negotiators.<sup>9</sup> Also, parties can pre-identify and avoid competitive negotiators, thus protecting themselves against exploitation.<sup>10</sup> The second effect of reputational information is dynamic: if negotiators know their reputational information is available and easily accessible, they have an incentive to foster an integrative reputation. The benefits of an integrative reputation (and the costs of a competitive reputation) will continue to increase as reputational information becomes more detailed and more widely disseminated.

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<sup>6</sup> See Susan T. Fiske & Shelley E. Taylor, *SOCIAL COGNITION* (1991).

<sup>7</sup> See e.g., sources cited *supra* note 2.

<sup>8</sup> Pareto-superior results, in other words. See sources cited, *supra* note 2.

<sup>9</sup> See Scott R. Peppet, *Lawyers' Bargaining Ethics, Contracts, and Collaboration: The End of the Legal Profession and the Beginning of Professional Pluralism*, 90 IOWA L. REV 475, 480-84 (discussion the problem of sorting "collaborators" from "hard bargainers").

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

Given all the benefits of integrative reputations, one might wonder why these reputations do not develop naturally. Many countervailing pressures limit or preclude the development of integrative reputations, particularly for lawyers. To begin, even if lawyers prefer in the abstract not to withhold information or behave competitively, “[t]he social incentives to deceit are at present very powerful; the controls, often weak.”<sup>11</sup> This incentive is particularly pervasive in law as adversarial lawyers are popularly seen as more effective, even if the data does not vindicate that intuition.<sup>12</sup> Clients, believing that only a hard-bargaining lawyer can get them the result they desire, increase the pressure for lawyers to behave competitively.

Moreover, the ethics of the legal profession arguably promote competitive negotiating behavior<sup>13</sup> and do little to prevent even outright lying in negotiation.<sup>14</sup> The clear normative message of the ethical rules is that concealment and deceit are allowed in negotiation; *a fortiori* hard bargaining and competitive behavior must be allowed. Not to bargain to the outer limits of the ethical rules may be seen as a professional failing on the lawyer’s part, or even as a violation of the lawyer’s duties under codes of professional responsibility.<sup>15</sup> Though the focus on problem-solving negotiation styles has increased in recent years, much of the literature advocates misleading behavior as a necessary component of negotiation.<sup>16</sup>

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<sup>11</sup> SISSELA BOK, *LYING: MORAL CHOICE IN PUBLIC AND PRIVATE LIFE* 244 (1978).

<sup>12</sup> Schneider, *supra* note 2, at 146-48 (discussing the depiction of adversarial behavior as the norm for attorneys in popular culture and legal articles).

<sup>13</sup> *Id.* (“The duty to zealously represent is often interpreted to mean that lawyers should negotiate by any means possible.”) (citing Model Code of Prof’l Responsibility Canon 7 (1979)).

<sup>14</sup> See U.C.C. § 2-312(2) (2004) (permitting “puffing”); WILLIAM LLOYD PROSSER ET AL., *PROSSER AND KEETON ON TORTS* § 109, at 757 (5th ed. 1984) (same); see also MODEL RULES OF PROF’L CONDUCT, R. 4.1 cmt. 2 (2007) (laying out “generally accepted conventions in negotiation” which are not prohibited under the Rules); Scott R. Peppet, *Lawyers’ Bargaining Ethics, Contract, and Collaboration: The End of the Legal Profession and the Beginning of Professional Pluralism*, 90 IOWA L. REV. 475, 499 (describing the Model Rules approach to negotiation ethics as “a fairly minimalist approach”).

<sup>15</sup> *Id.*

<sup>16</sup> See James J. White, *Machiavelli and the Bar: Ethical Limitations on Lying in Negotiation*, 1980 AM. B. FOUND. RES. J. 926, (“[T]he critical difference between those who are successful negotiators and those who are not lies in [the] capacity to both mislead and not be misled.”); Reed Elizabeth Loder, *Moral Truthseeking and the Virtuous Negotiator*, 8 GEO. J. LEGAL ETHICS 45, 46 (“Negotiation . . . appears inherently deceptive.”); Eleanor Holmes

In addition to the social incentives to avoid integrative behavior, reputational information is costly, if not impossible, to obtain, unreliable, and difficult to evaluate. In large legal markets, accessing high-quality reputational information about a counterparty is particularly difficult.<sup>17</sup> The information, if obtained prior to negotiation, may come from sources of uncertain trustworthiness. Information obtained during a negotiation is even more difficult to evaluate, as the other party may be giving misinformation intentionally. It is also difficult to distinguish someone's behavioral negotiating style from his true strategy, which compounds the risk of error.<sup>18</sup>

Additionally, the negative impact of engaging in cooperative negotiation with a counterparty who may exploit you is high enough that,<sup>19</sup> even with a relatively high level of confidence in one's judgment, it may still not be rational to pursue an integrative strategy. If one mistakes another attorney's reputation (or if that counterparty believes she can get away with "defecting" from her usual integrative reputation to realize gains), the other side might exploit cooperative behaviors and information-sharing to take all the potential gains from a given deal.<sup>20</sup> This caution, ironically, can cause one to behave in a more distrustful and competitive manner, which generally leads to worse overall outcomes.<sup>21</sup> Conversely, the more impact reputation will

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Norton, *Bargaining and Ethics of Process*, 64 N.Y.U. L. REV. 493, 508 ("The legitimacy, even *necessity*, of at least some deception in many traditional modes of bargaining makes it difficult to apply ordinary ethical notions of truthfulness in a systematic fashion.").

<sup>17</sup> See Peppet, *supra* note 9 at 487.

<sup>18</sup> See Goodpaster, *supra* note 1 at 329 ("[A] negotiator's behavioral style can mask or otherwise affect the strategy in actual use.").

<sup>19</sup> Though there are also negative impacts from misjudging a cooperative negotiator as a competitive one, but even if these impacts were symmetrical, loss and risk aversion effects, and the visibility of losses as opposed to the obscurity of unrealized gains, would likely make a negotiator discount these costs. See Richard Thaler et al., *Experimental Test of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325-48 (1990); but see Eyal Ert & Ido Erev, *Loss Aversion, Diminishing Sensitivity, and the Effect of Experience on Repeated Decisions*, 21 J. BEHAV. DECISION MAKING 575-97 (2008).

<sup>20</sup> Goodpaster, *supra* note 1 at 331 ("If a party knows or could somehow determine the other party's bottom line, that party would be at an advantage in any effort to maximize its gain at the expense of the other party.").

<sup>21</sup> See Tinsley, *supra* note 2 at 204; Leigh L. Thompson, *Information Exchange in Negotiation*, 27 J. EXPERIMENTAL SOC. PSYCHOL. 161, 177 (1991) ("[T]hese findings suggest that information exchange is difficult to elicit in

have on a given outcome, the more likely attorneys will be cooperative.<sup>22</sup>

Cheap, effective, and reliable information markets could provide negotiators with correct data about one another prior to negotiation. Disseminating reputational information will encourage negotiators both to share substantive information in the negotiation itself and to refrain from taking unfair advantage of one another's increased provision of substantive information. The literature predicts that this information will be underprovided by the market.<sup>23</sup> Formal reputation markets, then, would decrease transaction costs in the negotiation,<sup>24</sup> allow more efficient exchange of information and less time wasted in "feeling out" the other side. In addition, formal reputation markets would create significant dynamic efficiencies, as the wide dissemination of reputational information would decrease defections and encourage integrative behavior, as integrative bargainers would seek other integrative bargainers.<sup>25</sup> As increased integrative behavior produces better economic outcomes on the individual scale, aggregated increases in integrative behavior will produce better aggregate economic outcomes. Next I turn to the theory underlying reputation markets for lawyers.

### **III. Modeling Reputation Markets for Negotiators**

In their seminal paper on reputation markets for lawyers, Mnookin and Gilson take a model of litigation as a prisoners' dilemma game<sup>26</sup> between two individual disputants who

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negotiation and that negotiators may even resist or avoid information exchange."); Peppet, *supra* note 9 at 484 ("lawyers understand the strategic difficulties of trying to collaborate with an uncertain adversary, and they default to safer-- and more adversarial--approaches").

<sup>22</sup>Tinsley, *supra* note 2, at 204 (citing Orly Ben-Yoav & Dean G. Pruitt, *Accountability to Constituents: A Two-Edged Sword*, 34 *ORG. BEHAV. AND HUM. PROCESSES* 282).

<sup>23</sup> See Christopher Avery et al., *The Market for Evaluations*, *AM. ECON. REV.*, June 1999, at 565.

<sup>24</sup> See Goodpaster, *supra* note 1, at 338-39 (describing transaction costs in negotiations).

<sup>25</sup> See Peppet, *supra* note 9, at 482 ("[C]ollaborators will seek out other collaborators[.]").

<sup>26</sup> For a description of prisoners' dilemma games and the research and theory relating to them, see generally ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* (Revised ed. 2006).

choose between providing full information and avoiding discovery.<sup>27</sup> The disputants would both prefer to provide full information but fail to do so because they cannot make a credible commitment to one another, and each is desperate to avoid the “sucker’s payoff.”<sup>28</sup> Litigants can overcome this by committing themselves to using cooperative lawyers.<sup>29</sup> If such a decision is transparent and irrevocable (or only revocable with high switching costs) before the litigation game starts, then the cooperative outcome will be achieved.<sup>30</sup> The players’ dominant strategy is to choose a cooperative lawyer and defect only if the other side defects first. This model also applies in a transactional context.<sup>31</sup>

The basic model is problematic because it is predicated on the availability of lawyers with credible reputations for cooperation.<sup>32</sup> With these assumptions, we would predict a market for cooperative lawyers.<sup>33</sup> Clients would be willing to pay a premium for cooperative lawyers so they could achieve the higher payout in the litigation game, and lawyers would be willing to invest in establishing their reputation to garner higher fees.<sup>34</sup> An efficient market will be created so long as the loss in future fees exceeds the amount a client would be willing to pay to bribe a lawyer to defect (i.e., become non-cooperative for the next round of the litigation game).<sup>35</sup> Put

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<sup>27</sup> Ronald J. Gilson & Robert H. Mnookin, *Disputing Through Agents: Cooperation and Conflict Between Lawyers in Litigation*, 94 COLUM. L. REV. 509, 514.

<sup>28</sup> *Id.* at 522.

<sup>29</sup> *Id.* at 513. (“At the core of our story is the potential for disputing parties to avoid the prisoner’s dilemma inherent in much litigation by selecting cooperative lawyers whose reputations credibly commit each party to a cooperative strategy.”).

<sup>30</sup> *Id.* at 523.

<sup>31</sup> See Peppet, *supra* note 9 at 484 (“Transactional lawyers closing deals face similar challenges. If two transactional attorneys do not know each other, they may waste a great deal of time, money, and effort on verifying each other’s representations, drafting complex contracts that hedge against the risk of exploitation, and generally trying to protect against the possibility that they are dealing with a sharpie.”); see also Carrie Menkel-Meadow, *Toward Another View of Legal Negotiation: The Structure of Problem Solving*, 31 U. CAL. L. REV. 754, 758 n.6 (“While adversarial negotiation may be dysfunctional in litigation negotiations, it is likely to be even more dysfunctional in transactional negotiations, especially where the parties are forming a long term relationship.”).

<sup>32</sup> Gilson & Mnookin, *supra* note 27 at 524.

<sup>33</sup> Indeed, non-cooperative lawyers would soon become extinct in this assumed world.

<sup>34</sup> Gilson & Mnookin, *supra* note 27 at 524.

<sup>35</sup> *Id.* at 526.

differently, the goal is to decrease the non-cooperative payoffs to the lawyers such that cooperation will always be the dominant strategy. Putting one's reputation on the line serves to decrease the payoff or enhance the penalty of choosing non-cooperative behavior, and it is a species of commitment strategy.<sup>36</sup>

However, "the linchpin of this model is that the lawyer's cooperative or non-cooperative behavior be observable."<sup>37</sup> The model assumes that the other side's lawyer will be able to identify non-cooperative behavior when it begins and convey that information to his client, leading to the non-cooperative outcome. Mnookin and Gilpin go on to suggest a variety of reasons why the market would fail, most of which have to do with the incentives of individual lawyers to drive up litigation costs. These reasons are beyond the scope of this paper.<sup>38</sup> The article does, however, make one last assumption in the model which is the focus here. Once the information is observed, "both lawyer and client can impose the penalty of lost reputation on the misbehaving lawyer by distributing the information to the legal community."<sup>39</sup> The question remains: *how* will reports of this behavior be effectively disseminated to the legal community? To ensure the positive effects of increasing the transfer of reputational information, the information needs to be both correct and accessible.

Gilson and Mnookin posit a distinct reputation market for cooperative versus non-cooperative litigation behavior, which is easily transposed onto my framework of integrative versus distributive bargaining behavior.<sup>40</sup> I would add another factor to this reputational model:

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<sup>36</sup> See THOMAS C. SCHELLING, *THE STRATEGY OF CONFLICT* 29–30 (2d ed. 1980) ("[T]o commit in this fashion publicity is required . . . if the outcome is inherently not observable, the device is unavailable").

<sup>37</sup> Gilson & Mnookin, *supra* note 27 at 526.

<sup>38</sup> See *id.* at 528–534.

<sup>39</sup> *Id.* at 527; see also Peppet, *supra* note 9 at 485 (arguing that reputation markets cannot solve the sorting problem due to the size of legal markets and the lack of repetitive interaction).

<sup>40</sup> Thus, a similar Prisoners' Dilemma integrative negotiation behavior and distributive negotiation behavior as the two choices for the players.

the ability to make deals that are efficient<sup>41</sup> and last for the long-term. Competitive bargaining inhibits the ability to make efficient, long-term deals.<sup>42</sup> The lack of information transfer obscures possible gains to trade and raises transaction costs such that pursuing Pareto-efficient transfers is no longer worth the negotiation costs necessary to discover them.<sup>43</sup> It would also be useful for clients to be able to judge lawyers' reputations for creating deals that last and do not engender conflict, but the imposition of time and the lack of direct feedback currently obscure this mechanism.<sup>44</sup>

Cooperative reputations also create and enforce trust between the parties to the negotiation. If the two sides trust one another, they can "save time and energy constructing the agreement."<sup>45</sup> Trust also enhances the enforcement of deals on the back end, as each side believes the other will enforce the spirit of the agreement.<sup>46</sup> Though these arguments relate more to trust between the two parties, the level of trust between their lawyers – who, after all, are the drafters – will go a long way toward creating an atmosphere conducive to enforceable, agreeable long-term deals in which neither side feels exploited.

#### **IV. Potential Mechanisms for Formalizing Reputation Markets**

##### **a. Derivative Contracts**

A derivative contract, defined most simply, is a contract based on but independent of

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<sup>41</sup> In the sense that all possible gains to trade are exhausted.

<sup>42</sup> See Joseph Farrell, *Information and the Coase Theorem*, J. ECON. PERSP., Fall 1987, 113 (discussing inefficient outcomes driven by asymmetric information); see also Robert Cooter, *The Cost of Coase*, 11 J. LEGAL STUD. 1, 23 (1982) (noting that strategic behavior over dividing gains may inhibit Coasian, *i.e.* efficient, bargaining).

<sup>43</sup> See, HOWARD RAIFFA, *THE ART AND SCIENCE OF NEGOTIATION* 156-64 (1982) (discussing Pareto efficiency in negotiations).

<sup>44</sup> See ROBERT H. MNOOKIN ET AL., *BEYOND WINNING: NEGOTIATING TO CREATE VALUE IN DEALS AND DISPUTES* 137 (2000).

<sup>45</sup> Roy J. Lewicki, *Trust and Distrust*, in *THE NEGOTIATOR'S FIELDBOOK* 191, 191 (Andrea K. Schneider & Christopher Honeyman eds., 2007).

<sup>46</sup> *Id.*



another contract or asset.<sup>47</sup> I propose that the lawyers on both sides of a transaction create a derivative contract based on the original principal contract they are negotiating that rewards them for the performance of that principal contract. For example, such a contract might include a payment made to the lawyers if the contract expired with no successful suits for breach of contract on either side. In the case of long-term contracts, a contract might include staggered payoffs for the lawyers every *X* number of years the contract goes without a successful suit for breach. A contract could also contain a malus for the failure of the contract rather than a bonus for its success. In this case, lawyers could put up earnest money, similar to putting a deposit on a home, and would receive that money back (with interest) when the contract completed successfully or after a set period of time. There numerous ways to structure such a derivative contract; the essential point is that the lawyer or law firm has some financial stake in the success of the contract they have negotiated.

These derivative contracts would meet the theoretical question posed in Section II,<sup>48</sup> how to disseminate information to the legal community, in two ways. First, if cooperative behavior is necessary, or even helpful, for achieving long-lasting deals, then the payoff for non-cooperative behavior is decreased directly. Non-cooperative lawyers will either agree to the derivative contract and it will fail when the deal collapses, thus losing money, or they will refuse to agree to the contract and forego money they could have earned if the deal were accomplished and well-structured. Thus, if lawyers under this system behave in a non-cooperative fashion, they will forfeit the gains they might otherwise make or realize losses they could otherwise avoid.

More importantly, a derivative contract would function as a signaling device,<sup>49</sup> external

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<sup>47</sup> ANDREW CHISHOLM, DERIVATIVES DEMYSTIFIED 1.

<sup>48</sup> See *supra* Section II.

<sup>49</sup> See Schelling, *supra* note 36 at 26-34 (discussing credible signaling mechanisms used to solve Prisoners' Dilemma games).

to the parties' own representations, that allows a judgment to be made about the lawyers' confidence in their own integrative reputation. If clients notice that they are consistently not having to pay their contingent contracts, or they see that certain lawyers are not willing to write these sorts of contracts in the first place, the clients receive clear signals about the lawyer's own estimation of the likelihood of creating a long-lasting deal. Indeed, clients may take a higher risk of a deal falling through to forego having to pay a bonus as a sort of reputational risk premium. Derivative contracts may also prove to be a proxy signaling device for lawyers themselves if they can use their willingness to negotiate such contracts as a way of signaling commitment to a cooperative negotiation strategy.<sup>50</sup> The point is simply to increase the availability of information to allow clients to make as close to perfect-information choices as possible.

The willingness of lawyers on both sides to engage in these types of contracts will provide credible signaling information not only to their clients, but also to one another about their own estimations of the likelihood of long-term deal success.<sup>51</sup> Also, crediting lawyers more directly with the success of their negotiations gives extra incentive to collaborate, because collaboration is more likely to lead to a good deal (especially as opposed to the practice of billing by the hour, which incentivizes drawing out negotiations for as long as possible).

This is similar to the negotiation of contingency provisions within a contract, which are an effective way to create value between two parties.<sup>52</sup> In particular, these types of contracts meet the objectives of diagnosing deceit<sup>53</sup> and motivating performance.<sup>54</sup> Derivatives would make lawyers less likely to write a deal that they do not believe has a high chance of success. At

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<sup>50</sup> This is a somewhat diluted version what Peppet proposes as the "commitment to honest disclosure" solution that avoids some of the radical ethical revision that proposal requires. See Peppet *supra* note 9 at 492-95.

<sup>51</sup> See Peppet, *supra* note 9, at 484 (noting that "[c]redibility depends on the signal being costly for the actor, or impossible to mimic or revoke").

<sup>52</sup> See Max H. Bazerman & James J. Gillespie, *Betting on the Future: The Virtues of Contingent Contracts*, HARV. BUS. REV., Sept.-Oct. 1999, at 156-159.

<sup>53</sup> See *id.* at 158

<sup>54</sup> See *id.* at 159

the least, unwillingness to add a derivative could signal to the client in a less confrontational manner that the deal may be riskier than they had previously imagined. To some extent, this defuses some of the principal-agent tension inherent in the lawyer-client relationship by more closely aligning the incentives of the lawyer and the client. In addition, it encourages a higher level of performance and better drafting on the part of the lawyers. If part of their payment is contingent on their ability to write a contract that will last into the future, they have a greater incentive to work on making long-lasting deals, generating economic gains and decreasing transaction costs for both their clients and society. This benefit is realized most acutely if both negotiators have these derivative contracts. In this case, their incentives are aligned to share the most information possible and to produce the most robust, mutually beneficial contract.

Derivative contracts may present some difficulties, however,. First, lawyers must structure the derivatives in such a way as to overcome countervailing incentives to behave in a non-cooperative fashion. The bonus/malus would have to be enough to ensure good performance and to override incentives to behave in a non-cooperative fashion.<sup>55</sup> Two potential mechanisms could amplify the reputational effects of derivative contracts while decreasing the amount of money that would actually need to be put on the line.

First, a neutral party could publish a list of all the contracts and their statuses. This list would provide a public performance tracker; one could see at a glance which law firms and lawyers overall produced the best (as measured by lack of litigation and durability) contracts. A willingness to be published on the list might also be a credible reputational signal in and of itself. Some basic details would need to be published to give viewers a means of making valid

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<sup>55</sup> For a short list of some of these incentives, see Gilson & Mnookin, *supra* note 9 at 528–534.

comparisons, but a good overall sense of the firm or lawyer would likely be obtained.<sup>56</sup> By providing a public means of performance tracking, a lawyer would essentially be putting her (or her firm's) reputation on the line in every contract she made. This would provide the extrinsic penalty to non-cooperative behavior necessary to satisfy the theoretical condition given in Section II.

Second, lawyers could open the derivatives to a secondary market.<sup>57</sup> For example, a law firm could issue a derivative contract that would pay the firm \$100 on the successful completion of the contract, which has a duration of one year.<sup>58</sup> If the firm then resold that contract on the secondary market, the price for the contract would give a rough estimate of the probability that the deal will hold up.<sup>59</sup> Prediction markets aggregate local information from many individuals and thereby produce more precise probability estimates than any one actor could have produced.<sup>60</sup> Many derivative contracts would have to be issued to create a market that is sufficiently liquid to produce useful information, but they could be issued for lower prices. This would not substantially change the total cost exposure that the client would face if the contract was fulfilled. This market would allow anyone to have a quick look both at the history of the lawyer or firm's previous contracts as well as the currently estimated probabilities that their contracts will be successful. However, if the market is not sufficiently liquid, it may be subject to short-term manipulation.<sup>61</sup>

Derivative contracts are not without attendant risks and downsides. Certain conditions

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<sup>56</sup> It may, however, be difficult for users of this database to separate out the "noise" of economic conditions and other issues that could lead to a breach from the underlying ability of the lawyers to create a good agreement.

<sup>57</sup> For an introduction to prediction markets, see Justin Wolfers and Eric Zitzewitz, *Prediction Markets*, J. ECON. PERSP., Spring 2004, at 107.

<sup>58</sup> This type of contract is called a "winner-take-all" contract. See *id.* at 109.

<sup>59</sup> *Id.*

<sup>60</sup> Jennifer H. Watkins, *Prediction Markets as an Aggregation Mechanism for Collective Intelligence*, HUM. COMPLEX SYS., May 2007, 7–8, available at <http://repositories.cdlib.org/hcs/WorkingPapers2/JHW2007>

<sup>61</sup> See Francis A. Longstaff, *Asset Pricing in Markets with Illiquid Assets*, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=687298](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=687298)

must be present for a contract contingent on a future event to be successful, specifically a continuing interaction between the parties, enforceability, and transparency. Additionally, the contracts must discourage strategic game-playing.<sup>62</sup> Regarding the first condition, the parties must maintain a good working relationship. Fortunately, the lawyer-client relationship is particularly suited to continuing interaction; large firms rarely contract with clients for one-off spot transactions. However, enforceability presents potential problems. Since one of the parties is not receiving its full value up front, there must be some way of ensuring that the eventual “winner” will be able to collect.<sup>63</sup> In the case of large, established law firms dealing with large businesses, the reputational effects of failing to resolve debt, as well as the legal system, should be able to take care of most contracts with a minimum of conflict,<sup>64</sup> but lawyers should be careful to at least consider the risk of nonpayment. The third and fourth factors – transparency and discouraging strategic game-playing – blend together. Transparency refers to the clarity of the future event upon which the parties condition their contract<sup>65</sup> and deterring strategic game-playing refers to structuring the contract so that lawyers and businesses will not have extraneous incentives to interfere with its resolution. For example, a provision stating that the contract would pay out unless there was a suit filed for breach of contract would create the incentive for a business to file a frivolous suit simply to void the contract condition.<sup>66</sup> The contract should be clear and create a condition that is not subject to strategic gaming by either side or either side’s

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<sup>62</sup> See Bazerman and Gillespie, *supra* note 21 at 160.

<sup>63</sup> *Id.*

<sup>64</sup> This type of counterparty risk has, however, become more of a concern in the wake of counterparty defaults by firms that were thought to pose a low risk of such defaults. See generally CARMEN M. REINHART AND KENNETH ROGOFF, *THIS TIME IT’S DIFFERENT: EIGHT CENTURIES OF FINANCIAL FOLLY* (2009).

<sup>65</sup> Bazerman and Gillespie, *supra* note 21 at 160.

<sup>66</sup> This risk would be mitigated by the fact that the contingency payments to the lawyers would, in most cases, be much less than the continuing value of the agreement.

lawyers to avoid this pitfall is to make sure.<sup>67</sup> Finally, derivative contracts only work well in deal-making situations, not conflict resolution situations (although there is potential for a firm's reputation could spread from one area to another).

### **b. Ratings Clearinghouse**

In the past, it was difficult to get reliable information in advance of a purchase of a product or service. The cost of acquiring the information was high (i.e., someone had to buy the product and try it), and the cost of disseminating it was high because information was circulated by for-pay magazines like *Consumer Reports* or, in most cases, not at all.<sup>68</sup> While the cost of acquiring the original information remains high, the advent of computers and the Internet drastically lowers the cost of disseminating information.<sup>69</sup> Online systems such as the eBay user feedback system and the Amazon.com customer rating system have made it simple and nearly costless to disseminate information about products that one has tried, and databases combined with cheap processing power have made it simpler to deliver those results in a meaningful fashion.<sup>70</sup> An online rating agency would allow lawyers and clients to post feedback about one another. The agency could even be structured in such a way as to promote feedback in the areas research has deemed most useful to productive negotiation.<sup>71</sup>

Feedback about the performance of products has a noticeable impact on sales and revenue. One randomized study found an eBay seller with a high reputation could expect to earn 8.1% more revenue on similar products than one with no established reputation.<sup>72</sup> Another study

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<sup>67</sup> Possible resolutions to this problem include a mutually agreed-upon third-party evaluation of the merits of any claim filed, or a requirement that a claim survive a motion to dismiss before the payout is triggered.

<sup>68</sup> Avery, *supra* note 8, at 564.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> Indeed, simply providing the opportunity to rate lawyers or firms on aspects of performance that have been shown to improve negotiation results may induce people to pursue those reputational qualities.

<sup>72</sup> Paul Resnick et al., *The Value of Reputation on eBay: A Controlled Experiment*, EXPERIMENTAL ECON., June 2006, at 96.

indicated that buyers were willing to pay up to at least twenty percent more for a service that received a five-star rating than one which received a four-star rating.<sup>73</sup> Though legal services are more specialized, there is no reason to suppose law firms would be significantly less sensitive to ratings by clients and other firms than any other service.

However, an online rating database rating legal professionals would have to be carefully managed. Though this system takes a page from the eBay and Amazon.com systems, a legal reputation clearinghouse would need to be much more limited to preserve proper reputational signaling. Since each individual transaction is much more impactful than the mass consumer transactions reported on those websites, additional safeguards against manipulation are necessary. Many extant systems have been subjected to attempted or actual manipulation,<sup>74</sup> which demonstrates both that the ratings are effective and that they are likely targets of manipulation. The clearinghouse should require registration that can be fairly easily traced to someone who was a client or counterparty in a negotiation to ensure that the feedback is based on legitimate interactions. By improving the quality of information, the system becomes more robust against manipulation.<sup>75</sup>

Although perhaps a system such as this could degenerate into a means of score-settling and lose its usefulness as a way of signaling reputation, it is more likely that would effectively establishing fairly accurate reputational information at a low cost. The nonpublic behavior of the lawyer in the negotiating room would be made observable, both by other lawyers and by current

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<sup>73</sup> Comscore.com, *Press release: Online consumer-generated reviews have significant impact on online purchase behavior*, <http://www.comscore.com/press/release.asp?press=1928>, (2007).

<sup>74</sup> See, e.g., Chris Keall, *Belkin fakes Amazon customer reviews*, NAT'L BUS. REV., January 2009, available at <http://www.nbr.co.nz/article/belkin-fakes-amazon-customer-reviews-39651>; Physorg.com, *Engineers create system for combating manipulation of online product ratings*, <http://www.physorg.com/news160152872.html> (April 2009).

<sup>75</sup> Xiang Yan & Benjamin Van Roy, *Reputation Markets*, in APPLICATIONS, TECHNOLOGIES, ARCHITECTURES, AND PROTOCOLS FOR COMPUTER COMMUNICATION: PROCEEDINGS OF THE 3RD INTERNATIONAL WORKSHOP ON ECONOMICS OF NETWORKED SYSTEMS 79, 80 (2008).

and potential clients.<sup>76</sup> While it is true that both lawyers could simply provide each other with purely negative feedback,<sup>77</sup> a few factors would militate against the behavior. First, there is the prospect of “mutually assured destruction”, i.e. if one individual leaves a negative comment then the other will respond in kind. Second, client reviews would counterbalance other lawyers’ comments and give an independent observation of the lawyer’s behavior. Finally, and most importantly, negative reviews will be much less likely over time because the system makes negative interactions much less likely. If both sides come into the negotiation knowing the cost of non-cooperation is higher because its reputational effects are deeper and broader than they used to be, most will come to the conclusion that it is better to cooperate. This allows for more of what Lewicki describes as calculus-based trust.<sup>78</sup> In this condition, trust is sustained because “the punishment for not trusting is clear, viable, and likely to occur.”<sup>79</sup> Once collaborative reputations are established, they are likely to become self-fulfilling prophecies. If both sides expect collaboration, there is a high likelihood of fairly complete information sharing, which leads to the most efficient outcomes.<sup>80</sup>

Initial implementation would be the major obstacle to establishing a legal reputation clearinghouse. The system is initially dependent on a large number of users providing a large amount of feedback. Law firms and clients might be reluctant to spend time and effort signing up and managing feedback if the benefits were not immediately clear. Also, a clearinghouse’s operator would have to take steps to safeguard the system and prevent manipulation. Finally, someone has to pay for this system. Since, as I have conceived of it, the clearinghouse is a

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<sup>76</sup> This would solve the commitment issue identified *supra* in note 14.

<sup>77</sup> Conversely, lawyers could collude and drive up their reputational ratings though, again, this would be balanced by client-provided information.

<sup>78</sup> Lewicki, *supra* note 19 at 194.

<sup>79</sup> *Id.*

<sup>80</sup> Tinsley, *supra* note 1 at 207.



public good, no one would be willing to bear the costs alone to start it, as the benefits to any individual are not significant enough to justify the start-up costs.<sup>81</sup> Additionally, funding by law firms may create actual bias or the appearance of bias. Clients could pay a fee to access the database, but no one would want to pay before the database had been developed, and the database could not be developed without paying clients. One possible solution is to give early adopters free or discounted access, provided they populate the database with some initial information.

The Association of Corporate Counsel started a database for client reviews of law firms, mostly focused on the value-for-money aspect of law firm services.<sup>82</sup> Law firms have opposed the database, largely because the reviews can be anonymous and because firms initially were not allowed to view the results,<sup>83</sup> though that aspect has since changed.<sup>84</sup> A new reputational clearinghouse could easily piggyback onto this system by adding reputational elements to the rating matrix, providing an easy solution to the startup problem.

## V. Conclusion

A functioning market in reputation assists in inducing optimal cooperative behavior, in both litigation and deal-making contexts. The key theoretical point is that the punishment for defection must be increased extrinsically, through reputational factors, to make a commitment strategy viable and enforceable. To accomplish this, outcomes must be observable and made

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<sup>81</sup> Avery, *supra* note 8 at 566.

<sup>82</sup> Brian Zabcik, "How'd They Do? ACC to Introduce Client-Satisfaction Ratings of Law Firms," CORPORATE COUNSEL, Oct. 19, 2009, available at <http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202434681215&>

<sup>83</sup> Lynne Marek, "Who Posted This? Legal Consultant Criticizes ACC's Law Firm Rating Index," Nat'l L.J. Nov. 9, 2009, available at [http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202435243406&Who\\_Posted\\_This\\_Legal\\_Consultant\\_Criticizes\\_ACCs\\_Law\\_Firm\\_Rating\\_Index\\_\\_](http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202435243406&Who_Posted_This_Legal_Consultant_Criticizes_ACCs_Law_Firm_Rating_Index__)

<sup>84</sup> Amy Miller, "OK, Now You Can Look...ACC Lets Law Firms Access Client Reviews," CORPORATE COUNSEL, Feb. 9, 2010, available at [http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202442839445&OK\\_emNowem\\_You\\_Can\\_Look\\_\\_ACC\\_Lets\\_Law\\_Firms\\_Access\\_Client\\_Reviews](http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202442839445&OK_emNowem_You_Can_Look__ACC_Lets_Law_Firms_Access_Client_Reviews)

public in some fashion. This paper evaluated two potential mechanisms for establishing a market in legal reputation – derivative contracts and a ratings clearinghouse. Though neither is perfect, either could assist in increasing the dissemination of high-quality information about legal reputations, and thus lead to superior negotiating outcomes for all parties.<sup>85</sup>

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