DISCUSSION PAPER SERIES

No. 5959

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CEPR Discussion Paper No. 5959

November 2006

ABSTRACT

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Governance Reform in Legal Service Markets[*]

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Abstract

This paper discusses proposed governance reforms of legal sevices markets. The model distinguishes between a status quo position supported by a system of professionally enforced collective reputation and forms of governance based more squarely on market mechanisms. We identify a number of forces which determine the success of reform. Focussing particularly on the *rent recapture* and *relationship substitution* effects, we highlight their impact on client welfare and quality of legal services in different types of market according to whether clients are transient or repeated users of the service.

JEL classifications: D02, D78, D86.

1   Introduction

Markets for legal services are almost universally characterized by restrictions on market structures, self regulation and perceived high economic rents. However, the unique relationship between the judiciary, lawyers and the constitutional process, and the associated "political" power of the legal profession, has protected lawyers from the type of modernisation that has occurred in most professional services - the moot question is whether this has been for good or ill? Although there is an intensifying debate in most advanced countries centring on the sometimes archaic apparently self protecting structures and the quality of legal services, governments have proved very wary of changing the long-standing traditional structures that characterise the market. However, in response to a finding that the current regulatory framework for legal services was "outdated, inflexible, over-complex and insufficiently accountable and transparent"[1], the UK has decided to embark on a fundamental restructuring of the regulation of legal services and ownership structures. This includes replacing the traditional self regulation structure and allowing new ownership structures. These changes will take the UK legal services market into uncharted territory (it will be unique in the ownership and management structures that will be allowed).[2] While welcomed by consumer groups, these changes are extremely controversial and have met with almost universal criticism by legal associations around

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[*]We thank Heski Bar-Isaac, Jordi Blanes i Vidal, Clare Leaver and Osama Rahman. Also participants of the 2006 RES session on Law and Economics, and of the first IDF Delhi Conference on Governance. We also thank the editor and a referee for comments. Errors are all our own.

[1]Department of Constitutional Affairs (2003).

[2]For example, the American Bar Association's House of Delegates (the ABA's decision making body) recently ignored the recommendations of its own commission and rejected the introduction of new business models.

the world. For example, "both large and small member states condemned the proposals as posing a grave threat to lawyers' independence" at the 2005 plenary session of the Council of the Bar and Law Societies of the EU.[3]

Since these controversial changes merely allow lawyers to do what they currently cannot, the resistance presumably reflect a fear of their potential adverse *equilibrium* effects. We believe, therefore, that it is essential to structure the debate within an equilibrium framework. Any governance structure for transactions as complicated and elusive as legal services is multi-faceted. Explicit and implicit contracts, reputations, relationships, networks (by which important information is transmitted) all play a role in supporting the degree of efficiency achieved in legal services markets. To be specific, since courts find it difficult to determine the quality of delivered services that may be in dispute, these services are to a large extent, non-contractible.[4] Furthermore, many clients (notably private as opposed to large corporate ones), enter the market infrequently which makes it hard for them to assess and react to quality of service.[5] Such factors indicate that some clients may get poor quality for money and this is certainly borne out by anecdotal evidence. For example, a recent survey of dissatisfied legal customers found that the primary concerns were costs ("we feel that we were misled over costs from the very start") and poor business service as much as poor advice.[6] In the long-run, poor service will be met with a low willingness to pay for that service, and one can think of the potential bad equilibrium outcome between a lawyer acting opportunistically and a client who does not have the ability to gain redress for the poor quality of the services provided, as the "low quality-low price" benchmark that both clients and lawyers have an incentive to avoid. This is a classic 'governance' problem of the kind discussed and surveyed in Dixit (2004). We take the viewpoint therefore, that although the legal services industry supplies the foundations for the formal-contractual governance on which many transactions are based, it itself operates to a significant degree through the unwritten informal governance structures which have often been discussed in historical or development contexts. Of course, these mainly informal governance structures are typically referred to as 'professional' in this context but we believe it is appropriate to explore their operation and reform through the tools which have been developed primarily for use in areas where legal systems are weak.

The existing, status quo, solution to this governance problem is supplied by the legal professions themselves who have developed mechanisms to educate and discipline their membership to improve quality of service delivered and, consequently, the rents earned. A mechanism through which a strong form of this professional self-regulation can occur is what Tirole (1998) calls *delegated exclusion*. In the language of the profession, lawyers can be 'struck off'. Alternatively, or in conjunction, private clients may try where possible to use reputation from other purchasers and elsewhere as a guide.[7]

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[3]Law Gazette (2005).

[4]The following recently supplied Evidence to the Joint Committee on Draft Legal Services Bill by ROCAS (Reform of complaints against solicitors) makes the point "The position of solicitors in our society is unique in that solicitors are the gateway to remedies available to the citizen who has suffered a legal wrong. ... A client who brings a complaint against a solicitor is severely disadvantaged. ... Solicitors may have more legal knowledge ... They are in a position ... to generate evidence, ... If a client has a medical or financial complaint, he can turn to a lawyer for help. Unfortunately, as experience has shown time and time again, he cannot turn to another lawyer with any hope of getting real help if he has a legal complaint."

[5]See for instance Clementi (2004b) and Office of Fair Trading (2001).

[6]Consumer Association (2004).

[7]A survey of factors determining choice of solicitor by private clients found that almost half of those surveyed either

Tirole (1998) calls the refusal to purchase from suppliers with poor reputations *direct exclusion*, this is *one* way in which market forces work. Roughly speaking therefore, one can view a shift from delegated exclusion to direct exclusion as reflecting a shift from 'professional' governance to 'market' governance. It is important to note that in both delegated and direct exclusion equilibria, lawyers earn *rents* since it is the protection of future rents that provides the incentive to supply good service. In other forms of market based governance, specifically explicit contracting or relational contracting of the kind discussed below, incentives can be provided to lawyers absent the provision of future rents.

We believe that a simple but useful segmentation of the market for legal services can be made using two types of clients: infrequent-use clients such as most individuals and small firms and frequent-use clients, such as large corporate firms. In contrast to infrequent-use clients, a frequent purchaser typically has the advantage that he or she can have an ongoing relationship with a lawyer. This enables some of the payment from client to lawyer to be conditional on specific actions (i.e., the client can pay a bonus), and (using a "bonus trigger strategy" such as that used in Baker, Gibbons and Murphy (1994) and Dixit (2004)) the client will not renege on this providing it is beneficial to stay in the relationship. The possibility of rewarding lawyers by means of relational bonuses equips frequent clients with an additional tool for disciplining lawyers in what we might call relational contracts. Note however that in contrast to the direct exclusion mechanism, such relational contracts do not require lawyer rents in order to supply incentives. Of course, importantly, explicit formal contracts also share this lack of rents property.

Central concerns in the policy debate over the regulation of legal services (and many other professional services) have revolved around two types of regulation: (i) changes in regulation that may raise or set standards (identified as part of the objectives for regulation of the legal sector in Clementi (2004a)), and (ii) changes in the method of supply, notably along the lines of changing the legally approved business models, an issue which has been particularly contentious in legal services. Under (i) are the called for improved standards of transparency and accountability[8]. Few professional associations are likely to argue that they should not be accountable or transparent, but there is some discussion couched in the language of "light touch" regulation. In contrast, many of the legal suppliers argue that allowing non-lawyers to own legal firms will lead to short-termism and too much reliance on immediate profitability. For example, the Law Society (2004) claim that "there could be pressures in owner-managed firms to compromise fiduciary standards in order to achieve a desired level of profitability". On the other hand, there is a view among many other parties that the exact opposite would happen. For example, the Clementi Report (2004), when considering well-known commercial companies, argues that "unlike most high street solicitors, companies such as these have nationally known brand names to protect, which may be a powerful incentive to operate in a proper manner". That is, allowing well known commercial brand names to own companies that provide legal services may introduce stronger reputational concerns for legal service providers. The perspective taken by this paper is that such reputational forces are very much dependent on the levels of transparency and accountability which are likely to accompany any liberalisation of business structures.

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said that the firm had been recommended to them or they had chosen primarily on other grounds of reputation. Law Society (2000).

[8]See footnote 1.

By and large, replacing or rather attempting to replace profession-based discipline (which we model as supported by delegated exclusion) with market-based discipline (which we model as supported by a combination of direct exclusion and formal contracting) can erode or enhance the ex-post rents[9] earned by lawyers, client welfare, and aggregate social surplus and quality of legal services supplied. The paper documents a number of forces at work. There are *Gresham's law* effects, *informational efficiency* effects, *rent recapture* effects and *relationship substitution* effects. These effects, moreover weigh differently for different types of clients and impact differently under various policy regimes. The policy variables we discuss, which reflect the debate, are de-licensing, certification, transparency and accountability. We use de-licensing to describe a free-for-all situation in which clients can no longer distinguish between 'professional' lawyers and others claiming to provide legal services. Trivially, we identify a Gresham's law effect whereby just as bad money drives out good, bad lawyers drive out good. Certification however enables different types of supplier to distinguish themselves. Transparency supplies more information to consumers about the quality of services previously and currently delivered but is non-contractible. Accountability is information which can be used in contracts[10].

Consider for instance a policy of transparency. If the information that clients are now able to use to discipline lawyers is better calibrated to the clients preferences than the information that lawyers themselves use, then a more efficient equilibrium can be supported by direct exclusion than the one previously supported by delegated exclusion. In order to induce the extra effort from lawyers, greater future rents are necessary. Both clients and lawyers benefit and obviously aggregate welfare is increased. This is the information efficiency effect at work, the mechanism is relatively straightforward so in the main discussion we calibrate the model to eliminate it in order to benchmark the other forces. In contrast to transparency, increased accountability erodes the need for future lawyer rents to sustain performance and thereby sometimes enables clients to expropriate rents previously accruing to lawyers in circumstances when the terms of the trade-off are detrimental to aggregate surplus. This is the rent recapture effect. On the other hand, if accountability is sufficiently improved, direct contracting will lead to an efficient outcome. More detailed analysis and discussion is postponed to the body of the paper. It is important to point out that, in our model, aggregate social surplus as we measure it is one-to-one with the quality of legal services provided. We identify therefore circumstances where the quality of legal services and client welfare do not go hand in hand.

Central to the paper is the interaction between reputational and relational sub-markets. The importance of relational aspects in contracting was first highlighted by Macalay (1963) and Macneil (1974). Early formal models of relational (or implicit) contracts include Shapiro and Stiglitz (1984) and Bull (1987). Baker, Gibbons and Murphy (1994), Schmidt and Schnitzler (1995) and Dixit (2004) study the interaction between relational and formal contracts in the presence of asymmetric information, showing that in different circumstances these may be either complements, or substitutes. The role of reputations in inducing provision of higher quality of goods or services is studied in Klein

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[9]We do not model any ex-ante competition for these rents, presumably some of the rents are disbursed as subscriptions to the professional associations which support the equilibrium. Benham (1980) for instance argues "One of the most common ways of dissipating rents is by lengthening training programs. From the (profession's) standpoint this has the advantage that it can be legitimised on the grounds of raising quality. The longer and more specialised training in turn increaises the professional character of graduates, who ... are more aware of the close relationship between their own fortunes and those of the (profession)."

[10]Either private contracts or through a regulatory agency providing redress on behalf of clients.

and Leffler (1981) and Greif (1993) and Tirole (1996) among others.

The layout of the paper is as follows. The next section provides an outline of the core problem, the underlying model and a stylised status quo position supported by delegated exclusion. Section 3 addresses policy changes in two types of markets. We consider how de-licensing, certification, transparency, accountability and some combinations affect the client-optimal equilibria of the induced repeated game. Section 4 briefly considers how these effects interrelate when the different client types operate in a single market. Section 5 concludes.

2   Model and Status Quo Solution.

We model the situation as a simple one-sided prisoners' dilemma. If clients can't obtain redress from lawyers for poor service, then in the absence of some other form of governance mechanisms, lawyers have no incentive to incur costs in providing such services. Anticipating this, clients will be unwilling to pay and lawyers and clients fail to realise gains from trade. We suppose that the current status quo is one where this problem has been solved by legal professionals mutually disciplining each other by a system of what Tirole (1996) has called delegated exclusion. In practice, delegated exclusion does take place in legal services markets and is facilitated by a number of features. First, there is a system of occupational licensing which allows precisely this form of exclusion[11]. Second, the bodies which make such decisions are funded in advance by subscription so dynamic inconsistency issues are reduced. Third, the ultimate responsibility for such decisions rests at a very elevated position in the hierarchy, i.e. with someone well practiced in taking tough decisions[12].

For legal professionals, being struck off is certainly one of the most severe penalties that the profession can impose and therefore is the most effective in enforcing good behaviour. Members of the profession still have short term incentives to act opportunistically, but the loss of future earnings if struck off can counterbalance the temptation if the lawyer is sufficiently patient and the losses from being struck off are sufficiently high. We model the idea of lawyers' self-regulation by assuming that all practicing lawyers must belong to a "Lawyers' Association" (we have in mind of course the Bar Council and the Law Society), that can freely observe through the natural network of their mutual interactions the actions taken (which we simply model as a scalar effort level[13]) by each lawyer in every interaction with a client. We assume that lawyers are infinitely lived and have limited liability. Each lawyer has a discount factor $\delta \in [0, 1]$, and is matched with a client once per period.

Suppose that in order to maintain her membership to the association, each lawyer must exert a level of effort $\widetilde{a}$ (at personal cost $C(\widetilde{a}) = \widetilde{a}^2/2$) whenever the client offers an up-front payment $\widetilde{s}$ for the service. If a client offers anything else than $\widetilde{s}$, the lawyer's effort is not restricted. If a client

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[11]For instance: The *Roll of Solicitiors* is governed by the Solicitors Act 1974, a person cannot be admitted as a solicitor unless he or she has obtained a certificate from the Law Society. Once a certificate is obtained, an application is made to the Master of the Rolls to be admitted as a solicitor. Solicitors can be removed from the roll, or struck off, or have their practicing certificate suspended.

[12]For example the Master of the Rolls, is the third most senior judge of England, (subsequent to the Constitutional Reform Act 2005) ranking after the Lord Chief Justice and the senior Law Lord (President of the Supreme Court). Wikipedia lists the names of Masters of the Roll since 1286.

[13]This is for simplicity of exposition of the main points. In some respects it would be more natural to model actions as multidimensional and to consider imperfect linear measures of actions similar to Dixit (2004, Ch.2). Such an extension, would supply a more precise language with which to express the quality of information issues touched upon briefly in the paper but our main results would not be altered.

offers $\widetilde{s}$ and the lawyer puts in a level of effort different from $\widetilde{a}$, the lawyer is automatically excluded from the association.

We are looking for a self-regulatory professional equilibrium, where all lawyers exert $\widetilde{a}$ (and all clients pay $\widetilde{s}$). In order for such an equilibrium to emerge, three conditions must be satisfied:

(I) Lawyer's Participation Constraint (PC henceforth): each lawyer must be willing to provide her services, rather than opting out of the market.

(II) Lawyer's Incentive Compatibility constraint (IC henceforth): given the rules imposed by the association, each lawyer must not be tempted to deviate (by putting in effort level different from $\widetilde{a}$).

(III) Client's PC: Given the equilibrium strategy followed by the lawyer, each client must find it optimal to offer an up-front payment $\widetilde{s}$.

It is straightforward to see that the lawyer's participation constraint – given by $\widetilde{s} - 0.5\widetilde{a}^2 \geq 0$ – is always strictly satisfied whenever her incentive compatibility constraint is. The lawyer's incentive compatibility constraint requires that $\frac{1}{1-\delta}(\widetilde{s} - 0.5\widetilde{a}^2) \geq \widetilde{s}$ i.e.

$$\widetilde{s} \geq \frac{0.5\widetilde{a}^2}{\delta} \tag{1}$$

Client's PC: each client's payoff is $\widetilde{a} - \widetilde{s}$. Notice that if a client decides not to offer a contract specifying an up-front payment $\widetilde{s}$, his best option is that of offering no up-front payment at all (as the equilibrium does not restrict the lawyer's actions when she is offered anything other than $\widetilde{s}$). The client's PC constraint is therefore given by

$$\widetilde{a} \geq \widetilde{s} \tag{2}$$

Putting together conditions (1) and (2), we see that the effort levels that can be sustained in a self-regulatory equilibrium must satisfy

$$2\delta \geq \widetilde{a} \tag{3}$$

Note that in the nature of models of the kind under discussion, there are multiple equilibria. There is always a bad equilibrium in which lawyers provide poor service and are paid poor wages. Indeed, it is the existence of the bad equilibrium which sustain better ones in a subgame perfect equilibrium of the repeated game. Here, and throughout the paper, we concentrate on the equilibrium that maximizes clients' payoffs.[14] This is obtained by having the lawyer's IC constraint hold with equality. Each client's payoff is

$$\widetilde{a} - \frac{0.5\widetilde{a}^2}{\delta} \tag{4}$$

The equilibrium effort level maximizes (4) subject to (3) and is therefore given by $\widetilde{a} = \delta$. At equilibrium, each client's utility is 0.5δ, while the lawyer's payoff per period is $0.5\delta(1-\delta)$. Hence, lawyers earn positive rents at equilibrium. This is all very familiar. The presence of rents for a long-lived seller of legal services is necessary to ensure that the opportunity cost of defection is sufficiently

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[14]We are primariliy interested in understanding how the status quo compares to various market based governance reforms. From this point of view, the current assumpion casts the status quo in the most favourable light. We continue with the assumption throughout because the governance reform we consider (Clementi (2004)) proposes to admit competition between regulators, and this competition justifies the assumption.

high to induce her to respect the implicit agreement undertaken with the buyer.[15]

For convenience we record this supposed status quo outcome as

Result 1 (Status Quo): *When services are provided under a system of professional governance, i.e. supported purely by delegated exclusion, clients receive a payoff of* 0.5δ *and lawyers receive rents of* $0.5\delta(1-\delta)$ *per period.*

3   Legal Services Reform

This highly stylized status quo gives us a baseline from which to consider the possible impact of various changes to the regulatory regime. As discussed above, these are inspired by the Clementi (2004) proposals and the subsequent draft legal services bill in the UK together with various similar discussions currently occurring elsewhere.

First, however, we note that legal services come in disparate forms and there are important heterogeneities between clients. At one extreme there are *individual* clients who only interact with the legal system on a single occasion, or very few occasions, and who have poor information and understanding on how the law works. At the other extreme, there are major corporations who take few important decisions without first checking with their lawyers. Such corporate clients differ from the individual ones both by the repeated nature of interaction and in that they are likely to be able to better observe what it is that their own and other lawyers actually do. Initially, however, we distinguish client type only by the frequency of interaction. It is a convenient unifying expository device to treat all improvements in information as a policy change.

We turn therefore to policy interventions, which are analysed separately for both types of clients denoted I for individual, and C for corporate. It should be noted that in what follows we consider a setting in which the two types of clients operate in entirely separate markets. Discussion of the additional features introduced by allowing the two markets to interrelate is postponed to section 4. There are many examples of deregulation of specific legal services (e.g., notaries in Netherlands, conveyancing services in the UK) but these are usually accompanied by some residual regulation. The full open door de-licensing policy we consider below is unlikely to be proposed seriously or implemented, but serves as a useful benchmark *bad* policy, which would fully justify the reservations of the professional bodies. Discussion of this case also identifies one of the forces, bad for social welfare, which we aim to collect and classify. The point is, of course, that the effectiveness of policies depends crucially on the details. The details we shall be interested in revolve around how much and what type of information is made available to market participants. As discussed in the introduction, we distinguish between certification, transparency and accountability and the paper is structured to analyse the impact of various composite policies: entry of new types of legal service firms *plus* certification, *plus* transparency, *plus* accountability and *plus* various combinations. We are interested in analysing which constituencies (client, lawyers, and aggregate social surplus and the quality of legal services[16]) benefit or are hurt by the various policies. Initially, we suppose that consumers have no information whatsoever. They do not need it in the status quo because lawyers provide the discipline,

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[15]See for instance Klein and Leffler (1981).

[16]Recall, in the model aggregate social surplus is increasing in a and can therefore also be read as a measure of the quality of legal services supplied.

but will need to have some information if market based regulation is to be effective. In the following we begin with de-licensing the profession under this scenario and then in stages consider the impact of imposing certification, transparency and accountability.

3.1 New Suppliers

Policy 0. De-licensing. (Newcomers indistinguishable from existing lawyers are permitted). For both I and C clients, the "new" lawyers have, hereby by assumption, no mechanism to prevent opportunistic behaviour. Because indistinguishable from traditional lawyers, newcomers can make positive profits from poor service without suffering from delegated exclusion. This will result in clients paying for services that they often do not receive and the in the long run will imply that the price that clients are willing to pay for lawyer services will fall. This will also destroy the sustainability of non-opportunistic behaviour by 'real' lawyers since if the market is in a process of collapse, the incentives to make short term gains predominate over the gains from retaining membership of a moribund profession.

Policy I. Certification. (Newcomers are permitted but are distinguishable from existing lawyers) In the client best equilibrium, there is no entry of lawyers who are not subject to the professional discipline of delegated exclusion. The status quo is preserved by existing lawyers.

Result 2: *De-licensing alone decreases client and lawyer welfare through the Gresham's law effect. Certification restores the status quo but there is no entry.*

Policy 1 might be described as a debacle, while policy 0 is a disaster.

3.2 Policy II: Transparency

In practice transparency might involve establishing benchmarks, league tables etc., recording client feedback. The feedback ratings on many internet marketplaces such as e-bay is a good example of how such mechanisms can work in practice[17]. A lawyer acting opportunistically can therefore get a bad feedback rating or drop down the rankings and will find it hard to get repeat clients. We model the policy as rendering the lawyer's actions as observable to clients as they are to other lawyers, i.e. under the assumptions, perfectly. Recall, this information is currently assumed to be entirely non-contractible, something that will be relaxed separately in section 3.3.

I clients: Given the equal availability of information, an equilibrium exists in which essentially the same equilibrium as the status quo can be supported by what Tirole (1996) calls *direct*, rather than delegated exclusion. More specifically, communication between I clients creates a potential role for lawyer reputation. That is, the lawyer and the I clients can engage in a "reputational" contract (a trigger-strategy equilibrium sustained by a mechanism of multilateral punishment). Formally, a "reputational" contract (or equilibrium) is characterized by the variables $(\widehat{a}, \widehat{s})$ – where $\widehat{a}$ denotes the

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[17]On the other hand, there may be special features of legal services which make construction of such mechanisms more delicate. Specifically, advocacy services, by their nature typically produce one winner and one loser. Disgruntled losers are likely to give negative feedback even when they actually received good representation. We are grateful to Avinash Dixit for this remark.

effort level exerted by the lawyer and $\widehat{s} \geq 0$ denotes the (fixed) salary received by the lawyers along the equilibrium path – and takes the following form:[18]

Each I client proposes an up-front contract $pay = \widehat{s}$ (denoted as contract c^{good}) if the lawyer has a good reputation, while he offers $pay = 0$ (denoted as contract c^{bad}) if the lawyer has a bad reputation. A lawyer with a good reputation selects $\widehat{a}$ if she has been offered a contract c^{good} and reverts to statically optimizing behaviour otherwise. A lawyer has a good reputation if she has never dealt with I clients before or if she has exerted $a = \widehat{a}$ in all previous periods in which she has been dealing with I clients and has been offered a contract c^{good}. No requirement is imposed on the lawyer's behavior when offered a contract other than c^{good}.

In the same manner as the "self-regulatory" equilibrium studied above, a reputational contract needs to satisfy three constraints:

(I) Lawyer's PC: the lawyer must be willing to engage in the reputational contract rather than opting out of the market.

(II) Lawyer's IC: given the equilibrium strategy followed by clients, the lawyer must not be tempted to deviate (by putting in effort level different from $\widehat{a}$).

(III) Client's PC: Given the equilibrium strategy followed by the lawyer, each client must find it optimal to offer contract c^{good}.[19]

The characterization of the reputational contract mirrors that of the status quo equilibrium derived above. As in that case, we concentrate on the equilibrium that maximizes client payoff. This is obtained by setting $\widehat{a} = \delta$. Hence, just as in the status quo equilibrium, in the reputational contract each client's utility is 0.5δ, while the lawyer's payoff per period is $0.5\delta(1-\delta)$. Notice however that, as already mentioned, in contrast with the status quo case, here lawyer discipline is achieved by direct exclusion, rather than by delegated exclusion. At this level of analysis, and under the assumption that existing lawyers and entrants have the same discount factor and exclusion decisions are made on the basis of the same information, there is no reason to suppose that both kinds of organisation cannot coexist, implying that in the I market the existing market for lawyers need not be much disturbed by the improvement of transparency. Importantly, under either form of organisation, the suppliers of legal services require reputational rents to sustain non-opportunist behaviour.

C clients: We assume that a type C client is infinitely lived. Each C client's discount factor (denoted as ρ) may differ from the lawyers'. In the formal analysis below, we assume ρ is greater than or equal to the lawyer's discount factor δ. This case might apply if C clients are large stable, long-run organisations in comparison to the firms supplying their legal services.[20] The case where C clients are less patient than lawyers is analysed in similar fashion and is omitted for reasons of brevity, however the less patient case does lead to somewhat different conclusions which are presented in the statement of the resultS. Each C client requires legal support once per period. Hence, with respect to the market for I clients (who require lawyer services only once), the market for C clients possesses the advantage that the lawyer repeatedly interacts with the same client. This introduces the

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[18]Here and in what follows, we restrict attention to stationary contracts; because the game we consider is one of perfect information, this is without loss of generality (Abreu 1988).

[19]Note that it is always in the client's interest to offer c^{bad} to a lawyer with a bad reputation.

[20]The notion that firms/corporations may have longer horizons than individuals – and that indeed this may be a rationale for their very existence – is for instance discussed in Crèmer (1986).

possibility of a trigger-strategy equilibrium whereby the lawyer is offered an implicit-contract bonus (what the literature calls a "relational" bonus) whenever she complies with the implicit agreement (or "relational" contract) undertaken with the client. As we will see, this contributes to making cooperation between lawyer and client more easily sustained than in the market for I clients.

A relational contract (or equilibrium) is characterized by the variables $(\widehat{A}, \widehat{S}, \widehat{B})$ – where $\widehat{A}$ denotes the effort level exerted by the lawyer, $\widehat{S} \geq 0$ denotes the base salary, and $\widehat{B} \geq 0$ denotes the implicit-contract bonus along the equilibrium path – and takes the following form:

(i) if the lawyer has provided effort level $a = \widehat{A}$ in all past interactions (or if the lawyer has never previously interacted with the client), the client offers her a contract with a base salary $\widehat{S}$ every time he needs the lawyer's services. In addition, provided that the lawyer also puts in $a = \widehat{A}$ in the present interaction, the client pays her a relational bonus $\widehat{B}$.

(ii) if the lawyer has failed to provide $a = \widehat{A}$ in any of the previous interactions, the client offers a contract with zero base salary, and zero relational bonus in every period.[21]

(iii) the lawyer puts in $a = \widehat{A}$ in every interaction so long as the client has offered her a contract with a base salary $\widehat{S}$ and has paid her the relational bonus $\widehat{B}$ in every previous period (or if the lawyer and the client have never interacted before).

(iv) the lawyer puts in $a = 0$ in every interaction otherwise.

A relational contract needs to satisfy the following four constraints:

(I) Lawyer's PC: The lawyer must be willing to engage in the relational contract.

(II) Lawyer's IC: Given the equilibrium strategy followed by clients, the lawyer must not be tempted to deviate (by putting in effort level different from $\widehat{A}$).

(III) Client's PC: Each client must find it optimal to enter the relational contract.

(IV) Client's IC: The client must find it optimal to pay the bonus $\widehat{B}$.

Notice that constraint (IV) was not present when discussing reputational contracts in the market for I clients. The intuition is that, because clients of type I only interact with the lawyer once, they have no incentive to pay the lawyer a discretionary bonus whenever she puts in the desired effort level. Hence, discretionary bonuses cannot possibly feature in a reputational equilibrium. In contrast, here the lawyer interacts with the same C client all the time. In this case, therefore, fear of future retaliation by the lawyer can act as an incentive for the client. In turn, this provides an additional tool to sustain cooperation in the market.

It is easy to show that the lawyer's (respectively, the client's) participation constraint is always weakly (strongly) satisfied whenever her (his) incentive compatibility constraint is.[22] Hence, we only need to concern ourselves with incentive compatibility. The lawyer's incentive compatibility constraint requires $\frac{1}{1-\delta}(\widehat{S} + \widehat{B} - 0.5\widehat{A}^2) \geq \widehat{S}$ i.e.

$$\widehat{B} \geq 0.5\widehat{A}^2 - \delta\widehat{S} \tag{5}$$

Client's IC: the client prefers to pay the bonus $\widehat{B}$ rather than deviate from the relational contract if

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[21] This implicitly rules out the possibility that a defecting lawyer could restart a "good" contractual relationship with another C customer. As will become clear below, however, this is without loss of generality, as in equilibrium lawyers earn no rents when interacting with C clients, and could therefore not earn a positive return by deviating and starting afresh.

[22] The lawyer's and client's participation constraints are given by $\widehat{S} + \widehat{B} - 0.5\widehat{A}^2 \geq 0$ and $\widehat{A} - \widehat{S} - \widehat{B} \geq 0$ respectively.

$\frac{1}{1-\rho}(\widehat{A} - \widehat{S} - \widehat{B}) \geq \widehat{A} - \widehat{S}$ i.e.

$$\rho(\widehat{A} - \widehat{S}) \geq \widehat{B} \tag{6}$$

From (6) and (5) we see that the effort levels that can be sustained in a reputational contract must satisfy

$$\rho\widehat{A} - 0.5\widehat{A}^2 \geq \widehat{S}(\rho - \delta) \tag{7}$$

For any given $\widehat{S}$, and $\widehat{A}$, the client's payoff is maximized by having (5) hold with equality. In that case, the client's payoff is given by

$$\widehat{A} - 0.5\widehat{A}^2 + \delta\widehat{S} - \widehat{S} \tag{8}$$

The client selects $\widehat{A}$ and $\widehat{S}$ to maximize (8) subject to (7). It is straightforward to show that the equilibrium contract has $\widehat{S} = 0$ and $\widehat{B} = 0.5\widehat{A}^2$. The equilibrium effort level satisfies

$$\widehat{A} = \begin{cases} 1 \text{ if } \rho \geq 1/2 \\ 2\rho \text{ otherwise} \end{cases} \tag{9}$$

Because $\rho \geq \delta$, it is easy to see that the effort level (and the total surplus) that results in the C market under policy II is always higher than that which results in the I market, and in the self-regulatory equilibrium. Moreover, in the relational equilibrium, the lawyer is kept onto her reservation utility (and therefore obtains less than in the I market equilibrium, where she earns positive rents). Intuitively, this is because the relational bonus softens the lawyer's incentive compatibility constraint. Hence, in the C market the lawyer can be disciplined while earning no rents. Together, these two results – namely that $\widehat{A} > \widehat{a}$ and that lawyers earn no rents in the C market – imply that the utility obtained by clients in the C market under transparency is strictly greater than that obtained in the I market, and is therefore also strictly greater than what clients obtain in the baseline "status quo" scenario. This suggests that with transparency, in the C market we should expect the market-based relational equilibrium to displace the professional-based reputational equilibrium. In this case, transparency allows a form of "market discipline" to emerge, that improves the clients' position with respect to the "status quo", self-regulatory scenario. It is important to note however, that for the case where C clients are more impatient than lawyers (but not too impatient) clients can still rely on their own reputations to supply incentives in spot transactions, rather than rely on future rents to lawyers. C clients therefore can recapture some of the rents and be better off even when more impatient and therefore worse at sustaining reputations than their lawyers. This comes at the expense of aggregate surplus and the quality of legal services supplied. To summarise:

Result 3: *In the I market, transparency can facilitate entry of alternative business structures but the status quo payoffs for clients and providers of legal services are unchanged absent positive or negative information efficiency effects.*

In the C market, if the client is more patient than lawyers, transparency increases client welfare, decreases lawyer welfare and increases aggregate social surplus. If the client is less patient than the lawyer but not too impatient, then aggregate social welfare is reduced. If the C client is very impatient the situation is identical to the I market.

3.3   Policy III: Accountability

As indicated in the introduction, one way to think about modelling regulation that raises or sets standards is to interpret it as an increase in accountability and therefore an increase in what is contractible when purchasing services. We follow this route in this section. In this context accountability is equivalent to introducing (partial) verifiability of the lawyer's action.[23] This introduces the possibility for clients to write explicit contracts where the lawyer's compensation is contingent on some verifiable measure of effort. We suppose that partial verifiability takes the form that a court of law can costlessly verify whether a is above or below a certain threshold level $\underline{a}$. As mentioned in footnote 13, an alternative, superficially more attractive way capturing the impact of increased accountability would be to allow for lawyer actions to be multidimensional and introduce a contractible linear measure of performance which is imperfectly aligned with the objectives of clients along the lines of Dixit (2004). The results we obtain is the simple, one-dimensional case turn out very much the same as in the multidimensional case. In both instances, what matters is how close the available measure of performance is to the implemented policy (as measured by the projection of the policy onto the linear set defined by the measure).

We naturally restrict attention to $\underline{a} < a^* = 1$ – where a^* indicates the efficient (or first best) level of effort – and consider the effect of verifiability for each type of client in turn. First, we disengage policy II and consider policy III in isolation. We then analyze the impact of implementing policy III in conjunction with policy II.

3.3.1   Accountability alone

For this policy, the distinction between C and I clients is immaterial. When lawyer's actions cannot be directly observed by clients, raising accountability introduces the possibility of achieving cooperation by means of an explicit contract (denoted as c^E). Within this context, an explicit contract specifies a payment w offered to the lawyer whenever $a \geq \underline{a}$. The lawyer will select $a = \underline{a}$ whenever $w - 0.5\underline{a}^2 \geq 0$ i.e.

$$w \geq 0.5\underline{a}^2. \tag{10}$$

Given sufficient competition, (10) holds with equality. Clients will be willing to engage in the explicit contract (and pay $w = 0.5\underline{a}^2$) if

$$\underline{a} \geq 0.5\underline{a}^2 \tag{11}$$

which holds by the assumption $\underline{a} < a^* = 1$. When c^E is used, the equilibrium payoff for the lawyer is 0, while the payoff for each I client is $\underline{a}(1 - 0.5\underline{a})$.

The possibility of utilizing an explicit contract affects the client's participation constraint when dealing with "self-regulating" lawyers. In particular, clients may now resort to c^E, instead of relying on the self-regulating mechanism implemented by lawyers. Recall that each client's payoff in the status quo is 0.5δ. This brings us to our fourth result:

Result 4: *In the absence transparency, if accountability is not too weak ($\underline{a} > 1 - \sqrt{1-\delta}$), improved accountability increases the client's utility compared with the status quo (from 0.5δ to $\underline{a}(1 - 0.5\underline{a})$)*

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[23]Here, and in what follows, we use the expression "partial verifiability" and "enhanced accountability" interchangeably.

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and decreases the lawyer's per period ex-post rents (from $\delta(1 - 0.5\delta)$ to 0). Otherwise it leaves client and lawyer utility unchanged.

Aggregate surplus and legal service quality is unchanged for very low levels of accountability ($\underline{a} < 1 - \sqrt{1 - \delta}$), is reduced for moderate levels of accountability ($\delta > \underline{a} > 1 - \sqrt{1 - \delta}$) and is increased for high levels of accountability ($\underline{a} > \delta$).

Note that increasing accountability here can have a negative impact on social welfare through the *rent recapture* effect. Clients can motivate lawyers through explicit, but imperfect, contracts rather than as previously rely on the professional standards supported in a delegated exclusion equilibrium. For moderate quality of contracting, the professional standards will determine a more efficient standard of performance than the explicit contract, but what might be called the commoditisation and reduction in quality of legal services allows clients to recapture lawyer rents. Lawyers are hurt by commoditisation, but clients are not[24], however we will identify circumstances below where clients can be hurt.

3.3.2 Transparency and accountability together

We now characterize the effect of introducing policy III in the presence of information about lawyer's actions.

I Clients: In the market for I clients, increased accountability introduces the possibility of implementing a modification of the reputational contract seen above. A reputational contract is now characterized by $(\widehat{a}, \widehat{s}, \widehat{w})$, where $\widehat{w} \geq 0$ denotes the explicit contract payment, paid whenever the lawyer's effort is $\geq \underline{a}$.

The explicit contract offered along the equilibrium path, c^{good}, is now given by

$$pay = \begin{cases} \widehat{s} + \widehat{w} & \text{if } a \geq \underline{a} \\ \widehat{s} & \text{otherwise.} \end{cases}$$

We concentrate on characterizing reputational contracts that implement $\widehat{a} \geq \underline{a}$. This is because any reputational contract implementing $\widehat{a} < \underline{a}$ is necessarily strictly dominated by the explicit contract c^E in which the lawyer earns no rents.

Notice that if an I client decides not to offer c^{good}, his best alternative is that of offering c^E. Therefore, in equilibrium a lawyer with a bad reputation is offered an explicit contract c^E.

As in Section 3.2, the reputational contract needs to satisfy three constraints, namely (I) Lawyer's PC, (II) Lawyer's IC and (III) Client's PC.

The lawyer's PC constraint is always strictly satisfied whenever her incentive compatibility constraint is; hence, we only need to concentrate on the latter. Suppose that $\widehat{w} \geq 0.5\underline{a}^2$. In this case, a lawyer who decides to cheat on the reputational contract can maximize her present payoff by selecting $a = \underline{a}$. The lawyer's incentive compatibility constraint is therefore given by

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[24]Evidence to the 2006 Joint Committee on Draft Legal Services Bill by the Association of Personal Injury Lawyers: "APIL further believes that the supplying of legal advice is conducted as a profession rather than simply an industry. It would seem, however, that this distinction has been lost ... legal services, such as personal injury, will become 'commoditised'. It is extremely debatable whether the claimant (client) would regard this as a welcome development."

$\frac{1}{1-\delta}\left(\widehat{s} + \widehat{w} - 0.5\widehat{a}^2\right) \geq \widehat{s} + \widehat{w} - 0.5\underline{a}^2$ i.e.

$$\widehat{s} + \widehat{w} \geq \frac{\widehat{a}^2 - \underline{a}^2\left(1 - \delta\right)}{2\delta}. \tag{12}$$

Similarly, if $\widehat{w} \leq 0.5\underline{a}^2$ the lawyer's incentive compatibility constraint is

$$\widehat{s} + \widehat{w} \geq \frac{\widehat{a}^2}{2\delta} - \frac{\widehat{w}(1 - \delta)}{\delta} \tag{13}$$

Comparing this with the equivalent constraint under non-verifiability:

$$\widehat{s} \geq \frac{\widehat{a}^2}{2\delta} \tag{14}$$

we see that the total lawyer compensation per period required to discipline the lawyer under raised accountability is smaller than under non-verifiability. This is is similar to the findings of Baker, Gibbons and Murphy (1994), who in a model with asymmetric information and imperfect performance measure show that formal and implicit contracts may under some circumstances complement each other.

Client's PC: In contrast with the case in which effort is entirely non-verifiable, now the client's PC requires that each I client must prefer offering c^{good} (that is, engage in the reputational contract) to offering c^E (and only rely on an explicit contract). The client's participation constraint is therefore given by $\widehat{a} - \widehat{s} - \widehat{w} \geq \underline{a} - 0.5\underline{a}^2$ i.e.

$$\widehat{a} - \underline{a} + 0.5\underline{a}^2 \geq \widehat{s} + \widehat{w}. \tag{15}$$

Conditions (15) and (12) – respectively, (13) – are mutually consistent if

$$2\delta - \underline{a} \geq \widehat{a}. \tag{16}$$

As in the previous section, we concentrate on the equilibrium yielding the highest payoff to clients. This is obtained by having $\widehat{s} + \widehat{w} = \frac{\widehat{a}^2 - \underline{a}^2(1-\delta)}{2\delta}$, implying that the client's payoff is:

$$\widehat{a} - \frac{\widehat{a}^2 - \underline{a}^2\left(1 - \delta\right)}{2\delta}. \tag{17}$$

The equilibrium effort level maximizes (17) subject to (16) and is therefore given by:

$$\widehat{a}^v = \begin{cases} \delta & \text{if } \underline{a} < \delta \\ \underline{a} & \text{if } \underline{a} \geq \delta. \end{cases} \tag{18}$$

Each client obtains:

$$U_{client} = \begin{cases} 0.5\delta + \underline{a}^2 \frac{1-\delta}{2\delta} & \text{if } \underline{a} < \delta \\ \underline{a} - 0.5\underline{a}^2 & \text{if } \underline{a} \geq \delta. \end{cases} \tag{19}$$

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The lawyer's per-period payoff is given by:

$$U_{lawyer} = \begin{cases} \left(0.5\delta - \frac{\underline{a}^2}{2\delta}\right)(1-\delta) & \text{if } \underline{a} < \delta \\ 0 & \text{if } \underline{a} \geq \delta. \end{cases} \tag{20}$$

Recall that under the status quo we had $\hat{a} = \delta$, $U_{client} = 0.5\delta$ and $U_{lawyer} = 0.5\delta(1-\delta)$. It is straightforward to show that:

Result 5: *In the I market, in the presence of transparency, enhanced accountability strictly increases client utility and (weakly) decreases lawyer rents. If $\underline{a} < \delta$, client welfare is also higher than under accountability alone. If $\underline{a} > \delta$, aggregate social surplus (and quality of legal services) is increased, while if $\underline{a} < \delta$ aggregate social surplus is the same as with transparency alone.*[25]

C clients   A relational contract is now defined by $(\hat{A}, \hat{S}, \hat{B}, \widehat{W})$, where $\widehat{W} \geq 0$ denotes the explicit contract bonus paid whenever the lawyer's effort is $\geq \underline{a}$. As in the the previous subsection, we only consider $\hat{A} \geq \underline{a}$.

As in Section 3.2, the reputational contract needs to satisfy four constraints, namely (I) Lawyer's PC, (II) Lawyer's IC, (III) Client's PC and (IV) Client's IC.

We only need to concentrate on the lawyer and the client's incentive compatibility constraints. First, consider $\widehat{W} \geq 0.5\underline{a}^2$. In that case, the lawyer's incentive compatibility constraint requires

$$\hat{B} \geq 0.5\hat{A}^2 - 0.5\underline{a}^2(1-\delta) - \delta\left(\widehat{W} + \hat{S}\right). \tag{21}$$

Similarly, if $\widehat{W} \leq 0.5\underline{a}^2$ the lawyer's incentive compatibility constraint requires

$$\hat{B} \geq 0.5\hat{A}^2 - \widehat{W} - \delta\hat{S}. \tag{22}$$

It is straightforward to show that – as in section 3.2 – for a given $\hat{A}$ the client's payoff is maximized by setting $\hat{S} = 0$, $\widehat{W} + \hat{B} = 0.5\hat{A}^2$, implying that the lawyer earns no rents at equilibrium.

In the same manner as Baker, Gibbons and Murphy (1994) and Dixit (2004), we assume that if the client cheats on the relational agreement, the lawyer would refuse to participate in any future implicit contract but would be willing to consider explicit contracts and would accept an explicit contract if it were sufficiently attractive (i.e. giving her utility at least as high as her reservation utility, here set at 0). The client's incentive compatibility constraint is therefore given by $\frac{1}{1-\rho}(\hat{A} - \hat{S} - \hat{B} - \widehat{W}) \geq \hat{A} - \hat{S} - \widehat{W} + \frac{\rho}{1-\rho}\left(\underline{a} - 0.5\underline{a}^2\right)$ i.e.

$$\left(\hat{A} - \hat{S} - \widehat{W} - \underline{a} + 0.5\underline{a}^2\right)\rho \geq \hat{B} \tag{23}$$

Substituting for $\hat{S} = 0$ and $\widehat{W} + \hat{B} = 0.5\hat{A}^2$ we see that conditions (21)/(22) and (23) are mutually consistent if

$$2\rho - \underline{a} \geq \hat{A} \tag{24}$$

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[25]As for result 4, with respect to the status quo scenario aggregate social surplus is increased if $\underline{a} > \delta$, reduced if $(\delta > \underline{a} > 1 - \sqrt{1-\delta})$ and is unchanged if $(\underline{a} < 1 - \sqrt{1-\delta})$.

In this case, the client's payoff is

$$\widehat{A} - 0.5\widehat{A}^2 \tag{25}$$

The client maximizes (25) subject to (24). The equilibrium effort level satisfies

$$\widehat{A}_v = \begin{cases} 1 & \text{if } 2\rho - 1 \geq \underline{a} \\ 2\rho - \underline{a} & \text{if } \rho \geq \underline{a} \geq 2\rho - 1 \\ \underline{a} & \text{if } \underline{a} \geq \rho \end{cases} \tag{26}$$

Comparing[26] (26) with the equivalent requirement under (transparency and) full non-verifiability:

$$\widehat{A}_{nv} = \begin{cases} 1 & \text{if } 2\rho - 1 \geq 0 \\ 2\rho & \text{otherwise} \end{cases} \tag{27}$$

we see that the only situation in which raising accountability increases effort is when $\widehat{A}_v = \underline{a}$, $\widehat{A}_{nv} = 2\rho$ and $\underline{a} > 2\rho$. Notice that because the client obtains the whole surplus generated by the service, verifiability increases the client's welfare if and only if it increases $\widehat{A}$. This brings us to the following result:

Result 6: *Suppose, $\rho \geq \delta$. In the the C market, in the presence of transparency, enhanced accountability increases client utility and total surplus if and only if $\underline{a} > 2\rho$, decreases them otherwise. Lawyers' rents are unchanged.*[27]

To understand the result, it is instructive to compare the constraints placed upon what can be achieved by a reputational contract in this environment with those obtained when nothing is verifiable. The lawyer's incentive compatibility constraint is:

$$\begin{aligned} \widehat{B} &\geq 0.5\widehat{A}^2 - \delta\widehat{S} \text{ when nothing is verifiable} \\ \widehat{B} &\geq 0.5\widehat{A}^2 - \delta\widehat{S} - 0.5\underline{a}^2(1-\delta) - \delta\widehat{W} \text{ under partial verifiability} \end{aligned}$$

So under partial verifiability the lawyer's incentive compatibility constraint is more easily satisfied than under full non-verifiability. The client's incentive compatibility constraint is:

$$\begin{aligned} \widehat{B} &\leq \rho(\widehat{A} - \widehat{S}) \text{ when nothing is verifiable} \\ \widehat{B} &\leq \rho\left(\widehat{A} - \widehat{S} - \widehat{W} - \underline{a} + 0.5\underline{a}^2\right) \leq \rho\left(\widehat{A} - \widehat{S} - \underline{a}\right) \text{ under partial verifiability} \end{aligned}$$

So under partial verifiability the client's incentive compatibility constraint is harder to satisfy than under full non-verifiability. In summary, increased accountability has two effects: (i) the lawyer's IC constraint is easier to satisfy; and (ii) the client's IC constraint is harder to satisfy. The first effect is analogous within the C market of the result discussed above for the I market, namely that within our model, formal and informal contractual tools complement each other in disciplining the lawyer. The second effect is what we refer to as the *relationship substitution* effect. This stems

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[26]It is straightforward to verify that with respect to the the status quo and the "accountability alone" scenarios client's welfare and social surplus are increased and lawyer's welfare is decreased.

[27]If $\rho << \delta$, and $\underline{a} << 2\rho$, client utility will still be reduced but if this makes governance by delegated monitoring preferable to clients, it can *increase* aggregate surplus.

from the fact that the possibility of writing formal contracts improves the client's fallback position in the event of a breakdown of the relational agreement. In turn, this makes it harder to discipline the client, and therefore renders the relational contract harder to sustain. In our setting, the second effect always dominates in the C market.[28] Intuitively, this is the case because in the C market the client is already sufficiently powerful to allow him to strip the lawyer of all rents, even in the case where nothing is verifiable. Hence, in this market partial verifiability only helps when $\underline{a}$ is binding. Again, this is similar to Baker, Gibbons and Murphy (1994), Dixit (2004) and Schmidt and Schnitzler (1995) although the result is here obtained in a somewhat different setting.

Results 5 and 6 show that the welfare impact of improving accountability will differ across markets. In particular, while raising accountability increases the client's utility in market I, client utility may be adversely affected in the C market. Thus, with respect to policies directed at raising accountability, a tension exists between protecting the interests of different types of users of legal services. More generally, this result suggests that "one size fits all" policies may more elusive than may appear at a first glance. The impact of regulation may differ for different types of clients, implying that it may be difficult for regulators to protect the interests of all clients simultaneously.

3.3.3 Summary

The following table gives an overview of the broad shape of the results. Various policies are listed and the impact of the policy on clients, lawyers, and aggregate surplus/ quality of legal services is entered in the body of the table.[29] The effect of the first three policy measures (namely De-licensing, Certification and Transparency) is measured against the status quo scenario, in which lawyers self-regulate themselves. The effect of Accountability is measured first against the status quo scenario and then against a situation where transparency is present. For the C client market, the results refer to the case where $\rho \geq \delta$. The possible modifications that may emerge from the rent recapture effect when $\rho < \delta$ are in brackets.

Policy impact on clients, lawyers, aggregate surplus

	C-client market			I-client market		
	client	lawyer	surplus	client	lawyer	surplus
De-licensing	↓	↓	↓	↓	↓	↓
Certification	=	=	=	=	=	=
Transparency	↑	↓	↑ (↓)	=	=	=
Accountability						
– high level	↑	↓	↑	↑	↓	↑
– intermediate level	↑	↓	↓	↑	↓	↓
– low level	=	=	=	=	=	=
Accountability + Transparency						
– high level	↑	=	↑	↑	↓	↑
– low level	↓	=	↓ (↑)	↑	↓	=

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[28] Notice that the second effect is also present in the I market. There, however, this effect has no bite, yielding the result that raised accountability unambiguously increases client welfare.

[29] With ↑ (respectively, ↓) indicating a positive (negative) impact, and = indicating no impact.

4 Interrelated markets

In this section we briefly consider what happens when both types of clients operate in a single market. This introduces additional elements into the analysis because the lawyer's outside payoff when operating in a given market may now be given by what she could obtain in a different market. If skills are transferable, in order to attract lawyers, C clients will now have to match the rents offered by I clients. There are many permutations of possible scenarios and we do not attempt an exhaustive discussion. However, there are policy implications.

For example: First, let us modify our conception of a C client so that (realistically) such clients are now assumed to accrue the 'transparency' information through their own experience rather than through policy intervention. Second, suppose that professional regulation (delegated exclusion) is expensive so the rents of lawyers are dissipated in professional fees. Assuming uniform training and fees for lawyers regardless of client type, C clients will have to pay the ex-post rents to attract lawyers even though they can manage their own incentives as per section 3.2. Since they have to pay in any case, they are likely to be better off relying on professional governance rather than their own relational governance. Clearly, this creates scope in the market for entry into the C market by lawyers with a leaner professional governance structure. Since lawyer rents were previously dissipated, this is a social improvement and speaks in favour of the proposed reforms.

Alternatively, consider policies that enhance accountability and assume lawyer rents are not dissipated. As seen in section 3.3, in the I market these policies will lower the rents obtained by lawyers. This introduces an indirect benefit of such policies also for C clients, which was not present when considering separate markets. In that case, therefore, the inter-relation between the markets for C and I clients softens the conflict of interests between different types of clients, that was identified when discussing separate markets. One can show that the conflict is still present, but we omit the details[30].

5 Concluding Remarks

A central concern of the paper is to analyse the possible impact of legal services reform on clients, lawyers and the quality of legal services provided. We have emphasised that the governance of legal services is multi-faceted and that not only explicit contracts enforced by law, but also implicit ones supported by the reputations of lawyers and sometimes their clients all play a role in the degree of efficiency achieved.

We consider a series of stylised reforms, the first concern the introduction of legal service suppliers that are not subject to effective professional self regulation and when clients are insufficiently informed for market disciplines to work effectively. We argued that policy would at best maintain the status quo (in the case that existing lawyers can certify the distinction between themselves and the putative newcomers) and at worst (in the case in which the newcomers cannot be distinguished from existing lawyers) it would cause the market to collapse. This collapse is a consequence of the complete ignorance of consumers and therefore draws attention to the need to attend to making sure clients are adequately informed. We show that implementing this has many effects.

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[30]Available on request.

The second aspect of reform we consider is enhanced transparency and we show that its impact varies for different types of clients. Enhanced transparency increases the utility of long-lived corporate clients who are able to use the information to leverage their own reputations and thereby partially resolve the governance problem in a relational contract. In such a contract, the rents accruing to lawyers is reduced compared to the status quo and the impact on the quality of legal services and aggregate surplus depends on whether the clients or the lawyers are better at carrying the requisite reputations (this depends on their relative discount factors). The quality of legal services, for example, suffers when clients substitute a less efficient governance arrangement for a more efficient one in order to recapture rents that otherwise accrue to lawyers.

We then consider enhanced accountability. We show that, absent transparency, an increase in accountability will increase clients' welfare whenever the minimum level of effort that can be guaranteed by explicit contracts is not too low, however if it is sufficiently far from the first best, the quality of legal services can again suffer via the rent recapture effect. If accountability is increased in conjunction with transparency then the impact of the policy varies dramatically between markets. In the I market, increased accountability unambiguously increases clients' welfare, and decreases the lawyers' utility. In contrast, in the C market, increased accountability increases client welfare only when the minimum level of effort that can be guaranteed by explicit contracts is sufficiently high, and decreases it otherwise. This perverse effect arises because the cost of a breakdown of relational governance is reduced by the enhanced contracting options, the relationship substitution effect.

Some general lessons emerge: Policies may have opposite effects in different markets. For example, with respect to raising accountability, a potential tension exists between protecting the interests of different types of users of legal services. Therefore, in drawing up the details of reform, it may be appropriate to design the details differently for different sectors. Specifically, regulation might attend more to the rights of individual clients in e.g. family law cases than to large corporations who not only can look after themselves but may be better off if allowed to do so.

Second, the modelling approach although simple does allow a conflict for some policies between the welfare of clients and the quality of legal services provided. To the extent that the latter is an objective in itself there is a tension between the two which the paper makes more precise. In the model, lawyer rents typically increase with the quality of legal services so a reflection of this conflict in objectives should be expected in the debate over reform. This feature of the debate is easy to document but hard to pin down, and this paper supplies one way to view it. This view leads to a positive prediction that the professional agencies (even if only acting in the ex-ante interests of their members) should resist some reforms and should welcome or even instigate some others. For example, regulating services in a manner that provides greater transparency *may* be a good strategy for a professional association to adopt if delegated monitoring and exclusion is costly and transparency enables reputational monitoring of the market to govern its behaviour more cost effectively. Such policies should naturally be part of a reputational self-governance strategy of an association. Our modelling approach predicts that this is more likely in I markets than C markets. It may be easier for different front-line regulators to deal with the separate markets rather than have a single agency. Free entry of front-line regulators is part of the reform package currently under discussion.

Third, the effect of policies is rife with nonmonotonicities. Tokenism can be worse than irrelevant, it can harm clients and the quality of legal services. For example this happens in result 6,

where accountability is good only if provided in adequate quantity. This weighs against "light touch regulation" in certain markets.

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