Business Lawyers and Value Creation for Clients

Ronald J. Gilson
Columbia Law School, rgilson@law.columbia.edu

Robert H. Mnookin

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Symposium on Business Lawyering and Value Creation for Clients

RONALD J. GILSON*
ROBERT H. MNOOKIN**

Foreword: Business Lawyers and Value Creation for Clients

This Symposium marks an important milestone in legal scholarship and education: The spotlight falls on business lawyers for a change. Ten years ago, when one of us first wrote about what business lawyers really do,¹ no one had devoted much attention to this part of the profession. In his broadside

* Charles J. Meyers Professor of Law and Business, Stanford University, and Marc and Eva Stern Professor of Law and Business, Columbia University.
** Samuel Williston Professor of Law, Harvard Law School, and Chairman, Steering Committee, Harvard Program on Negotiation, Harvard University.
against lawyers, Derek Bok, then President of Harvard University and formerly dean of its law school, reserved his invective for litigators and the litigation process. Business lawyers captured the attention of very few critics; even on the unusual occasion when we were noticed, the criticism was at least funny. If the litigators got Shakespeare's incitement to legacide, we got Kurt Vonnegut. Some of you may remember Vonnegut's primer on the lawyer as transaction cost engineer, in which a popular law professor tells his students that to get ahead in the practice of law "a lawyer should be looking for situations where large amounts of money are about to change hands." Give Vonnegut credit—he saw the central importance of a transactional focus only a few years after Coase. Vonnegut goes on:

In every big transaction [the professor said], there is a magic moment during which a man has surrendered a treasure, and during which the man who is due to receive it has not yet done so. An alert lawyer will make that moment his own, possessing the treasure for a magic microsecond, taking a little of it, passing it on. If the man who is to receive the treasure is unused to wealth, has an inferiority complex and shapeless feelings of guilt, as most people do, the lawyer can often take as much as half the bundle, and still receive the recipient's blubbering thanks.

Now compare the articles that comprise this issue of the Oregon Law Review. Karl Okamoto, for example, considers the importance of reputation in business practice; Ed Bernstein, a practicing business lawyer, approaches contract drafting from a value creation perspective; and Robert Thompson extends the transaction cost engineer paradigm to include failures in cognition. And just as there are lessons for practice in these pages, so too are there lessons for pedagogy: A value creation focus can

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3 KURT VONNEGUT, GOD BLESS YOU MRS. ROSEWATER 17-18 (1965).
5 VONNEGUT, supra note 3, at 17-18.
help legal academics do a better job of teaching students how to be business lawyers.

We intend to take advantage of having the first word in these proceedings by dropping the cloak of academic neutrality to proselytize shamelessly for the approach this Symposium highlights. At a time when lawyers have come to doubt the professional conception of their calling, the self-confidence that grows out of a focus on value creation may provide a much needed counterweight. As our own contribution, we want to provide the substantive foundation for that self-confidence by highlighting the parallel intellectual development of two intrinsically linked themes still commonly treated as separate: transaction cost theory as a guide to creating value, and negotiation theory as a guide to understanding the process by which the value created is divided.

We have always known that value creation and value division are central to what business lawyers do, but we lacked the theory to make positive or normative statements about either the activities or their relation. Over the last ten to fifteen years, developing theory has created the potential for both scholarship and pedagogy in this area. Transaction cost economics, agency theory and finance have illuminated the value creation element of business lawyering. Game theory, cognitive psychology and social psychology have done the same for value division. And rational expectations theory has demonstrated the link between the two: expectations of how the value created will be divided influence the likelihood that it will be created in the first place. At this point, the link between our two points appears: The ability to harness theory to improve practice provides a solid foundation for renewed professional confidence.

I

BUSINESS LAWYERING AND PROFESSIONALISM

Bemoaning a decline in the professionalism of lawyers has become commonplace in recent years. Sol Linowitz and Mary Ann Glendon have offered book length treatments,9 and the law re-

view literature is enormous. But for our purposes here, Tony Kronman, the dean of the Yale Law School, frames the issue most directly. In *The Lost Lawyer*, Dean Kronman describes a profession "in danger of losing its soul," for him the spiritual coupling of intelligence and character epitomized by the "lawyer-statesman." The specter is of future generations of legal janissaries who possess large measures of intelligence, skills and loyalty, but who lack the commitment to integrate those traits into broader conceptions of the wise or the good. In Kronman's analysis, attorneys lose the practical wisdom resulting from this integration and consequently the distinguishing characteristic of the lawyer-statesman and the highest aspirations of the bar.

For this Symposium, the important part of Dean Kronman's account is less the model of professionalism the lawyer-statesman represents than the analysis of the cause of the decay. Here Kronman's account shares a common ground with some other recent accounts—the analysis remains largely legal centric, embracing an unremitting belief that the profession itself controls the operative conditions of its own professionalism. Kronman acknowledges changes in the character of the demand for legal services, in particular the growing professionalization of clients. But he contends that the real culprit lies within the profession and, more specifically and surprisingly, within the law schools, especially the elite law schools. We part company with Dean

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14 KRONMAN, supra note 11, at 276. We do not come to this issue without preconceptions. Both Gilson & Mnookin, supra note 10, and Gilson, supra note 10, advance the thesis that the principle agent of change is on the demand side of the market for legal services, in particular the dramatic reduction in the information asymmetry between lawyer and client that, in the past, accounted for the market power which sheltered much of the behavior we associate with professionalism.
Kronman on this causation issue.\textsuperscript{15}

So who kidnapped the lost lawyer? The law schools! The villain in Dean Kronman's mystery is the change in substance and pedagogy that has occurred in legal education—the displacement of traditional case analysis by both law and economics and critical legal studies.\textsuperscript{16} To summarize (which does justice neither to the skill with which Dean Kronman deploys the argument nor to its gossamer quality), case analysis forces students to immerse themselves deeply both in the facts of a case and in dissecting the legal rules by which the court links those facts to a normatively appropriate outcome. The repeated discipline of developing normative principles only through confronting the complexities of real life hones the attribute of practical wisdom: Lawyers learn to craft imperfect but workable solutions to problems whose complexity defies perfection. When turned loose upon the world after law school, lawyers end up in charge in just those circumstances where practical wisdom is necessary; lawyer-statesmen thrive on the uncertainty inherent in ascertaining the appropriate normative principles to be applied to complicated, institutionally contingent problems.

Dean Kronman believes this skill, which marks the lawyer-statesman (and which, we note, bears passing resemblance to the current resurgence in pragmatism), is the casualty of the increasing dominance of a social science orientation in law schools—whether grounded in neoclassical economics or European sociology. Both law and economics and critical legal studies, Kronman argues, are ultimately reductionist: Each abstracts away complexity in favor of simple theorems. Students thereby lose the discipline of having to account, positively or normatively, for the institutional detail that honed the practical wisdom of Dean Kronman's lawyer-statesman.

Viewing the past through the nostalgic shimmer of time masks many of its blemishes.\textsuperscript{17} Consider instead a different account of

\textsuperscript{15} We should temper our criticism of the analysis by acknowledging our respect for the effort. Rarely have we so admired the motivation and sincerity of an inquiry with whose conclusion we so fundamentally disagreed.

\textsuperscript{16} See Kronman, supra note 11, at 225-64.

\textsuperscript{17} Robert Gordon, The Independence of Lawyers, 68 B.U. L. Rev. 1, 2-6 (1988), demonstrates this point in connection with the recurrent phenomenon of each generation of legal literature announcing the decline of professionalism. An eighty year old quote from Louis Brandeis illustrates Gordon's point:

It is true that at the present time the lawyer does not hold as high a position with the people as held seventy-five or indeed fifty years ago; but the
the relation between the case method and practical wisdom. In any law school class, only a fraction of the students possesses judgment when they graduate and we are skeptical whether the law school experience accounts for even this fraction. Indeed, we suspect that some students come to law school with practical wisdom already in hand and may well have had it when they were twelve years old. To be sure, the case method effectively poses the problem for the large number of less favorably endowed students: How does the lawyer find the normative needle in the haystack of factually complex settings? But it gives no guidance concerning what to do then. At its extreme, the case method provides lawyers with the analytic tools to spot problems, but not the skills to solve them. And this ability to spot issues but not necessarily solve problems gives rise to the perception that lawyers are deal killers who highlight so many unresolvable issues that the transaction ultimately collapses. The reductionism of early law and economics and critical legal studies seems to us an understandable reaction to the case method's core problem in training lawyers. Ultimately, both ends of the law school ideological spectrum railed at the case method's indeterminacy.

For us, the excitement of this conference is the potential that the various methodologies canvassed hold for teaching just those things that Dean Kronman's idealized case method never did—that is, the bundle of skills that he collectively calls practical wisdom. Transaction cost economics, the economics of information, the positive theory of agency, and the theoretical basis of negotiation share a common goal—to understand the complexity of transactions and institutions by focusing on their imperfections. We can teach contracting techniques that mitigate the pervasive information asymmetries between the contracting parties which stand as a barrier to almost every transaction. We can teach how

issue is not lack of opportunity. It is this: . . . [L]awyers have, to a large extent, allowed themselves to become adjuncts of great corporations and have neglected the obligation to use their powers as for the protection of people.


18 It is a closer question whether the argument also is founded on hubris—can any technique of law school pedagogy really have the socializing force that Kronman assigns the case method? Here, however, we share his belief in the transformative power of professional pedagogy; it is, after all, the lever of influence on which we rely as well. Of course, that does not resolve the question of hubris one way or another.
attention to the availability of market remedies—for example, the role of reputation and the promise of future dealings—may provide alternatives to costly and ineffective litigation remedies.\textsuperscript{19} We can teach how incentive structures can be fashioned to minimize the trade-off between risk sharing and incentives.\textsuperscript{20} We can teach how decision theory can help focus what issues really affect a transaction's outcome. To the extent law schools can teach these skills—and the articles contained in this issue and our own experience hold out that promise\textsuperscript{21}—then we will do a far better job than the case method purveyors of Dean Kronman's golden age could ever have imagined. We will send out from law school more students with judgment than just those who arrived already possessing it. And if the changing character of the demand for legal services has compromised a lawyer's autonomy,\textsuperscript{22} then a new opportunity to perfect our craft provides a foundation for building professionalism in the new environment in which we find ourselves.

II

VALUE CREATION AND VALUE DIVISION

That brings us to our second point—examining more concretely how theoretical advances from the social sciences give credence to our claim both that we now have the knowledge to teach judgment and that lawyers are particularly well-placed to accomplish it. As a vehicle we will use the new understanding of the relation between value creation and value division.

We are committed to the notion that lawyers can often create value, not just as business lawyers who serve as transaction cost

\textsuperscript{19} Bernstein, \textit{supra} note 7, provides an interesting account of how the deficiencies of litigation remedies shape the structure of transactions.

\textsuperscript{20} Paul Milgrom & John Roberts, \textit{Economics, Organization and Management} ch. 7 (1991), provides an approach to this problem that we have found useful in teaching from a transactional perspective. It is a different puzzle to explain why Dean Kronman, who certainly knows the literature, ignored the new institutionalism of recent law and economics, highlighted by the award of the Nobel Prize in Economic Science to Ronald Coase, in his analysis of the impact of law and economics on law school pedagogy. The \textit{Lost Lawyer}'s index, for example, includes only one passing reference to the work of Oliver Williamson.

\textsuperscript{21} This is our goal in developing negotiation courses at Harvard and "deals" courses at Stanford and Columbia that seek to harness sophisticated theory to the task of teaching professional skills.

\textsuperscript{22} See Gilson & Mnookin, \textit{supra} note 10; Gilson, \textit{supra} note 10. In this respect, the professions stand together. Physicians and public accountants seem to us to be further along the path dictated by increasing client sophistication.
engineers,\textsuperscript{23} but also as litigators who cooperate to facilitate efficient dispute resolution,\textsuperscript{24} and as process architects who design efficient systems to resolve conflict outside of court at low cost.\textsuperscript{25} But we are not naive enough to believe that lawyers—even the business lawyers whose virtues are celebrated in this Symposium—necessarily accomplish these goals. Indeed, the purpose of our Foreword is to explain why this is so and how the social sciences (Dean Kronman notwithstanding) can provide valuable insights both to practicing lawyers and legal academics.

To understand why lawyers may or may not end up creating value, it is necessary to understand (1) the sources of the value creation, and (2) the negotiation process through which value may or may not be created, and the barriers that may sometimes lead to negotiation failures. Because we have each written about these issues in more detail elsewhere, our summary here will be very abbreviated.\textsuperscript{26}

We begin with the sources of value creation. Economic theory provides a useful framework for understanding the basic sources—the raw materials—from which value can potentially be created by transaction cost engineers. These sources relate to: (1) differences; (2) non-competitive similarities; (3) economies of scale and scope; and (4) developing structures for dampening strategic opportunism and reducing transaction costs.\textsuperscript{27}

The first, and perhaps most general, source of value creation relates to differences between the parties. Students in negotiation courses often erroneously believe that win-win negotiations somehow depend on finding similarities—common interests shared by both sides. In fact, it is characteristically differences in preferences, relative valuations, predictions about the future, and risk preferences that fuel value-creating opportunities. The basic principle is fundamental to economics: Trade should occur—and surplus can be created—when one party places a high relative value on a good or service that the other party values less highly.

\textsuperscript{23} See Gilson, supra note 1.
\textsuperscript{24} Gilson & Mnookin, supra note 10.
\textsuperscript{25} \textit{Beyond Litigation: An Interview with Robert H. Mnookin}, \textit{Stanford Law.}, Spring/Summer 1989, at 45.
\textsuperscript{26} See Gilson, supra note 1; Robert Mnookin, \textit{Why Negotiations Fail: An Exploration of Barriers to the Resolution of Conflict}, 8 Ohio St. J. on Disp. Resol. 235 (1993); \textit{Barriers to Conflict Resolution} (K. Arrow et al. eds., 1995).
For example, a vegetarian with a chicken and a carnivore with a large vegetable garden will find it useful to swap what they have for what they don't have. Because substantial barriers exist to direct trade of unlike commodities, lawyers can add value by creating the structures by which these differences can be arbitrated.

A second source of value creation is non-competitive similarities. Public finance theory has long taught that police protection, national defense, and clean air all represent economic goods in which more for the Smiths does not necessarily mean less for the Joneses. In some instances, the interests and preferences of parties to a negotiation may be such that each may enjoy added benefits without diminishing the other's enjoyment. For example, a divorcing mother and father may both derive benefits from their child's emotional well-being and educational achievements. Establishing a good working relationship is another example of non-competitive similarities: Improving communication between business partners will characteristically benefit both partners.

Economies of scale or scope—in both production and consumption—provide the third category of value-creating opportunities. Many economic transactions in which lawyers play a critical role involve pooling the production or consumption facilities of different parties so that the unit cost will drop as a function of increasing volume or range of activities. Creating or preserving the structures that capture such economies is an important source of value creation.

The fourth source of value creation relates closely to recent work in transaction cost and agency economics. Lawyers can often play a role in creating incentive structures that dampen the potential for opportunistic behavior. This is not to say that the problems of asymmetric information, adverse selection, and moral hazard can be vanquished from the world through good lawyering. It is, however, a matter of degree; lawyers can often create procedures and institutional structures that diminish the risks by either minimizing asymmetries or aligning incentives.

These sources often provide the potential for lawyers to struc-
ture transactions that create value. But that potential must be realized through a process, and that process is typically negotiation. Descriptively, business lawyers spend a good deal of their time engaged in negotiation. Moreover, whether lawyers in a particular transaction in fact succeed in creating value depends importantly upon their negotiation skills. That value creation typically occurs through negotiation poses two risks. First, the negotiation process itself can sometimes be so costly and time consuming that the potential surplus is dissipated even though the transaction is completed. Alternatively, the negotiation process may fail entirely, so that no transaction is consummated even though the potential to create value existed. These risks result from the barriers to successful negotiation that arise in just those circumstances where negotiation has the potential to create value. The rub lies in the fact that the process of negotiation both creates the value and distributes it among the parties involved: A client hires a lawyer not simply to enlarge the pie, but also to maximize the size of her slice.

Sketching the outlines of a few of the potential barriers to value creation through negotiation provides a useful introduction to the problem. In light of Dean Kronman’s discomfort with the growing role of social science in law schools, we think it significant that our understanding of these barriers has greatly benefitted from important research across several social science disciplines. A review of four potential barriers illustrates this basic claim.

The first—what one of us has characterized as a strategic barrier—is inherent in the very process of negotiation. Each party’s desire to claim as much value as possible for herself may inhibit or prevent the cooperation necessary to value creation. Lax and Sebenius have characterized this tension as the “negotiator’s dilemma.” When negotiators structure a deal that creates value, the result is to enlarge a pie that must be divided; but who gets what size slice also must be resolved. All negotiations thus inevitably involve questions of distribution. And practitioners will express no surprise at the fact that clients often may care more about the size of the slice than the size of the pie. Econo-

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31 These ideas are developed in more detail in Mnookin, supra note 26, and Robert Mnookin & Lee Ross, Introduction, in BARRIERS TO CONFLICT RESOLUTION, supra note 26, at 2.
32 See Mnookin, supra note 26.
33 See Lax & Sebenius, supra note 27.
mists have long observed that an individual client may prefer points beneath a Pareto-frontier to many outcomes on the frontier.

An important source of this tension between value creation and value division relates to information asymmetries. Value creation characteristically requires parties to honestly share their private information so that they can fully identify and exploit differences in relative valuation, opportunities for non-competitive similarities or scale or scope economies, or the possibility to align incentives. The basic difficulty is that honestly sharing information exposes a party to the risk that the other party may behave strategically. Hence, a dilemma. In order to create value, a party may wish to be open himself and encourage the other side to be open as well. Disclosure that one party prefers apples and the other oranges creates the potential for value-creating trade. But the fear of exploitation may make each party reluctant to disclose to the other information that is critical to value creation. Once one side discloses that she prefers the other's apples to her oranges, the apple holder may strategically misrepresent her taste for oranges to influence the terms of the trade.34

Even in the absence of information asymmetries, strategic behavior over division may interfere with actually creating the gains. Parties may be tempted to use threats and various commitment strategies to claim for themselves the lion's share of the gains from cooperation. If both parties engage in such hard bargaining, the result may be no deal at all, or so long and conflictual a negotiation process that a large portion of the potential surplus is wasted.35

A second barrier will be familiar to those readers with some exposure to recent work concerning principal/agent problems. The economic literature on agency, and scholarship relating to transaction cost economics, teaches that an agent’s incentives cannot be perfectly aligned with those of her principal. Using an agent allows the principal the benefits of the agent’s special knowledge, skills, and resources. However, the interests of an agent negotiating on behalf of a principal may be a barrier to reaching an agreement that would benefit the principal. For example, critics often claim that litigators are themselves a barrier to the efficient resolution of business disputes through early set-

34 See Mnookin, supra note 26.
35 See id.
tlement. High discovery costs surely contribute to the income of partners in many large American defense law firms. Similarly, the fact that plaintiffs' lawyers paid on contingency largely bear the costs of trial surely leads to some settlements that are not in the clients' interests.  

Business lawyers can also be villains in some principal/agent stories. Like the target company executives who see themselves at risk if a hostile take-over succeeds, a lawyer who will lose an important client if a merger succeeds may sometimes stand in the way of an acquisition that would substantially benefit his client. None of this is to deny that lawyers—and agents generally—contribute substantially to value creation. We simply wish to underline that agents often may be conflicted, with the result that less value is created.

Strategic barriers, and those resulting from principal/agent issues, reflect models of human behavior premised on rational, self-interested parties seeking to maximize their own interests. Other barriers, our understanding of which grows out of path-breaking scholarship in psychology, are based on different behavioral models. These barriers arise because parties are subject to psychological processes that sometimes render them unable to recognize as advantageous agreements or settlements that really are in their rational self-interest. To make matters even worse, psychological barriers may exacerbate the effect of strategic barriers. As one of us has written, "[b]asic cognitive and motivational processes do in fact create barriers to dispute resolution that augment and interact with barriers arising from strategic calculation." Psychological blinders may so shrink the perceived opportunity for value creation that even small amounts of strategic behavior overwhelm the process.

This is not the place to attempt an exhaustive summary of these psychological barriers. But we can point to a number of cognitive processes—such as "optimistic overconfidence" (relating to the fact that uncalibrated assessments of probability are often more extreme than the assessors' knowledge can justify), "loss aversion" (relating to our tendency to care more about avoiding a loss than securing an equivalent gain), as well as difficulties arising from the heuristics that are used by people to evaluate uncertainty—which interfere with effective negotiation by

36 See Gilson & Mnookin, supra note 10.
37 Mnookin & Ross, supra note 31, at 2.
even well-intentioned parties, let alone those acting strategically.\textsuperscript{38}

In addition to barriers that relate to how human beings process information, there are also social-psychological barriers. Lee Ross has identified a barrier that he called “reactive devaluation.” Ross’s research suggests that particularly where negotiators view each other as adversaries—that is, when dividing the value created looms large in the parties’ minds—they devalue concessions offered by the other side simply because of their source. As Ross has written: “To the extent that adversaries devalue the compromises and concessions put on the table by the other side, they exacerbate an already difficult dilemma: that of forging an agreement that the relevant parties with their differing views of history and their differing views of entitlement, will perceive to be better than the status quo and not offensive to their sense of equity.”\textsuperscript{39}

This brief review of four different types of barriers is meant simply to underline a fundamental point: While lawyers may often play a very constructive role in creating value, value can only be created through a process—characteristically negotiation—that may sometimes fail. It is also meant to suggest that at a very deep level Dean Kronman was badly mistaken when he argued that the insights of social sciences have subverted the legal profession and the legal academy. The cadre of lawyer-statesmen whom Kronman venerates—composed of those students who came to golden age law school with judgment already in hand—intuitively saw the opportunities to create value and sensed the barriers to successful negotiation that stood in the way. We believe that creative use of the insights of the social sciences holds the potential to raise the rest of us to that level, a result that can only increase the professionalism of the bar, both in its public contribution and in the satisfaction of craft it can provide its members.

As this Symposium and our remarks suggest, the insights of the social sciences also create special opportunities for legal scholars. In many respects, legal academics are particularly well suited to the interdisciplinary effort necessary to exploring how

\textsuperscript{38} See Daniel Khaneman & Amos Tversky, Conflict Resolution: A Cognitive Perspective, in BARRIERS TO CONFLICT RESOLUTION, supra note 26, at 44.

\textsuperscript{39} Lee Ross, Reactive Devaluation in Negotiation and Conflict Resolution, in BARRIERS TO CONFLICT RESOLUTION, supra note 26, at 33.
our legal system, and private parties transacting in its shadow, behave. To the extent that legal academics share a common disciplinary core beyond facility with the output of courts and legislatures, it is a commitment to the importance of a deep and sensitive institutional knowledge. However, as legal scholars we are reasonably free of disciplinary restrictions on the tools that can be deployed in aid of our task. Legal academics may take economic analysis as far as it goes, but then switch to cognitive psychology or sociology to fully close the jaws of our analytic vice. In this respect, we have the opportunity to use borrowed concepts and apply them with a freedom that our sisters and brothers in particular social science disciplines probably cannot. We salute this Symposium and the University of Oregon School of Law for encouraging this sort of work. In the end, it holds more promise than a return to what Langdell incorrectly called the science of law.