

The Contingent Fee

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Benefits of Contingent Fees

- Improved alignment of lawyer and client interests, which is important due to the difficulty of client monitoring.
 - Wouldn't it be nice to have contingent fees in other areas of the economy?
- Greater access to the legal system.
 - The contingent fee lawyer is the venture capitalist of the legal system.

- ## Contingent Fee Lawyers Screen Cases

- Elihu Root once observed that, “About half of the practice of the decent lawyer consists in telling would-be clients that they are damned fools and should stop.”
- Contingent fee lawyers will tell their clients they are damned fools more often than hourly-fee lawyers.
- Testable implication: Drops will be higher under hourly fees.
 - Intuition: As time passes and cases move through the system clients gain information. With better information some clients with weak cases drop their cases. In other words, some of the hourly-fee clients learn what a contingent-fee lawyer would have told them on day one and they drop their cases, wiser but poorer.
- Some states restrict contingency fees, especially in medical malpractice cases. We can expect that in these states and types of cases a greater proportion of lawyer compensation is “hourly,” thus we predict drops will be higher in states that restrict contingency fees.

Two Tests of the Relationship Between Contingency Fees and Drops

1. Different states at a single point in time. We compare drops in states that limit contingent fees in medical malpractice cases (but not other types of cases) with drops in states that do not limit contingency fees. We use auto cases, on which contingency fees are not limited *in either type of state*, to control for other factors.
2. The same state before and after restrictions on contingency fees. We use a short treatment window to control for other factors.

Results: Drops are Significantly Higher In States that Restrict Contingency Fees

		Total Cases	Dropped Cases	Proportion
States with Limits on Contingency Fees in Medical Malpractice Cases (Hourly Fee States)	Medical Malpractice	454	83	18.3%***
	Auto	4838	468	9.7%
States w/out Limits on Contingency Fees	Medical Malpractice	287	14	4.9%***
	Auto	3474	353	10.2%

*** The difference between these two percentages is statistically significant at the greater than 1% level.

Test Two of the Relationship Between Contingency Fees and Drops

- Florida limited contingency fees in November of 1985.
- We look at drops in a 300 day window before and after Nov. 1985 – the narrow window controls for other factors.

Results: Drops in Florida Increase after Contingency Fees are Limited

Period	Total Cases	Dropped Cases	Proportion
Pre Limits (1985)	1938	440	22.7 percent**
Post-Limits (1985-1986)	1064	279	26.2 percent**

**Difference is statistically significant at the 5% level.

Costs and Criticisms of Contingency Fees

- A lawyer has a greater incentive to settle than her client because the lawyer bears all the costs of a trial but receives only $1/3^{\text{rd}}$ of the benefits.
- Simple solutions are available:
 - Raise the contingency fee conditional on going to trial, eg. 25% if settled, 33% if case goes to trial.
 - Split the costs and benefits between client and lawyer equally. E.g. lawyer gets $1/3^{\text{rd}}$ of settlement but only bears $1/3^{\text{rd}}$ of cost.
- The empirical results show no large settlement effects.

- Time to settlement

- Olson (1991a) writes:

- “Most litigants tire of their fights, if not at first, then after a while, and at some point would rather get on with their lives than hold out for a little more. The lawyer with a big war chest has an incentive to make you wait in order to go for the extra money.”

- Yet Bernstein (1996) argues that “[b]ecause time is most definitely money in the legal business, it pays the contingent-fee attorney to settle as quickly as possible...”.

- Contingency fee lawyer can’t win!

- We think Bernstein is correct, cases will be quicker under contingency fees but we put this in a more positive light. An hourly-fee lawyer will have an incentive to rack up the hours!

- Results using the same data as earlier.

- States that have restrictions on contingency fees increase the time to settlement by 22 percent – this is relative to auto cases as a control (and other factors)

- Time to settlement in Florida increased by 13 percent after contingency fees were restricted

Excessive returns to contingent-fee lawyers?

- Lester Brickman (2003, 657) writes:
 - ...Contingent-fee lawyers have not only flouted ethical rules and fiducial protections but have also imposed substantial rents on tort claimants as the price for tort claiming...contingent-fee lawyers generate substantial rents and obtain inordinately high rates of return, not infrequently amounting to thousands and even tens of thousands of dollars an hour.
- Assume that damages are uncertain with a $\frac{1}{2}$ probability of \$25,000 and a $\frac{1}{2}$ probability of \$5,000 then in some winning cases the equivalent hourly fee will be \$833 and in others just \$166.
- Recall our earlier analogy to venture capitalists. It's common to hear about venture capitalists who multiply their investment 10 or even 100 times but those huge returns are paralleled by many investments that return little or nothing.
- Legal disputes are tournaments with big first-prizes and lousy second-prizes. Hence the market for lawyers is similar to a winner-take-all market. The big-name lawyers, Joe Jamail, Dickie Skuggs, etc. are the superstars of their profession and are paid exorbitantly for the same reasons that Julia Roberts and Derek Jeter are paid exorbitantly.
- Data collected by Kritzer (2002) indicate that hourly and contingent fee lawyers make about the same. *Economic theory predicts it could not be otherwise.*

Contingent Fees and the Social Interest

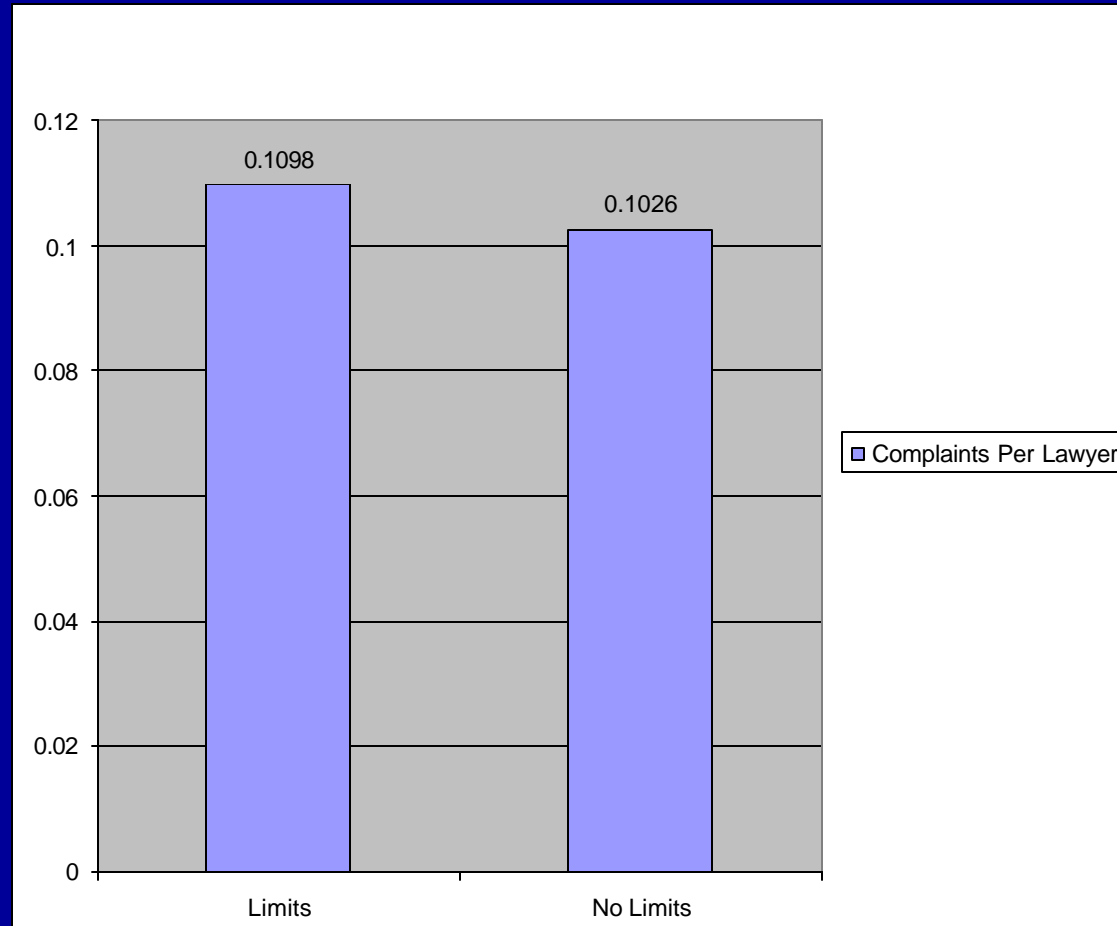
- We have found no strong evidence that contingency fees harm the interests of clients. On the contrary, we have found evidence that restrictions on contingency fees contribute to wasted plaintiff effort and longer times to settlement. Not too surprising: client's watch out for their own interests and the market for lawyers is competitive.
- Olson (1991) notes, however, that:
 - The case against the contingency fee has always rested on the danger it poses not to the one who pays it but to the opponent and more widely to justice itself. As other nations recognize, it can yoke together lawyer and client in a perfectly harmonious and efficient assault on the general public. *There are things lawyers will do when a fortune for themselves is on the line that they won't do when it's just a fortune for a client.*
- The raw data, however, does not appear to be consistent with this argument.

Awards in Medical Malpractice Cases are *Higher* in States that Limit Contingency Fees

	Mean Award	Obs.
Medical Malpractice Cases in Limit States	\$500,816	327
Medical Malpractice Cases in No Limit States	\$225,105	313
Auto Cases in Limit States	\$173,886	708
Auto Cases in No Limit States	\$99,119	954

- If contingency fees significantly increased the incentive of lawyer's to behave unethically we ought to see this in complaints.

Complaints per Lawyer are Similar in States that Limit and Do Not Limit Contingency Fees in Medical Malpractice Cases (2001, 2002)



Discussion and Conclusions

- Market for lawyers does have some peculiar aspects. Competition appears to be primarily on non-price grounds leading to an inefficient over-supply of lawyers - similar to what we see in the real-estate market.
- Contingent-fee reformers have some good ideas such as basing fees on *additions* to settlement.
 - But note that this would make contingency fees much higher even though on a smaller base!
- Restrictions on contingency fees, however, are unlikely to be a good method of tort reform.
- Interfering with freedom of contract often has unintended effects. Restrictions on contingency fees increase drops and lengthen the time to settlement.
- There are many problems with the tort system. But how we pay lawyers is not the or even a driving problem. We have paid lawyers using contingent fees for over a hundred years. Tort reformers cannot shy away from advocating substantive changes in the law.