Two Cheers for Contingent Fees

AEI LIABILITY STUDIES

Michael S. Greve

Series Editor

The AEI Liability Studies examine aspects of the U.S. civil liability system central to the political debates over liability reform. Individual studies analyze the consequences of important liability doctrines for consumer welfare and productive efficiency, assess the effectiveness of recently enacted liability reforms, examine intricate jurisdictional and institutional dilemmas, and propound original proposals for improvement. The goal of the series is to contribute new empirical evidence and promising reform ideas that are commensurate to the seriousness of America's liability problems.

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Alexander Tabarrok and

Eric Helland

HARM-LESS LAWSUITS?

WHAT'S WRONG WITH CONSUMER CLASS ACTIONS

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Foreword

The "liability explosion" would be much easier to address if it were in fact, as the term implies, a sudden event with a specific cause. But the expansion of legal liability beyond its traditional common-law boundaries has been a gradual, evolutionary process, with numerous interwoven causes. For example, until a century ago tort cases were, for the most part, disputes between citizens of the same political jurisdiction, decided by local judges and juries. With the emergence of large corporations and the growth of interstate commerce, tort cases increasingly pitted local plaintiffs against out-of-state citizens or corporations with highly diffused ownership—but were still decided by judges and juries of the plaintiffs' states or communities, whose tendency to dispense justice with more attentive sympathy for neighbor-plaintiffs than for foreigner-defendants was strong and systematic. Beneficial economic developments produced an unfortunate byproduct: the transformation of a system of dispute resolution into the unconstrained imposition of a tort tax.

The progressive expansion of liability had many political, intellectual, and even cultural causes in addition to economic ones. Although many changes in legal doctrines and procedures were reasonable adaptations to social change, by the end of the twentieth century the system as a whole was producing many results that were manifestly unjust, socially harmful, and economically counterproductive. Still, the movement for legal reform was as slow and complex as the phenomena it responded to. Not only had freewheeling liability produced a politically powerful interest group adamantly opposed to reform—the trial lawyers—but the

liability system itself was highly decentralized, with many subtle features and interdependent parts. Many proposals to improve it by revising one or another legal rule foundered on the problem of top-down regulation: Revising a single feature of a complex system leads the other features to respond in kind, which may leave matters even worse than they were before. Only in recent years, a quarter-century after the liability explosion first attracted political notice, have state and federal reforms begun to appear with serious evidence or prospects of yielding tangible improvements.

The problems of excessive legal liability have been a longstanding concern of the American Enterprise Institute. In this monograph series, AEI aims to inform the growing political debates with original, intellectually rigorous research and scholarship by some of America's leading students of law and economics. Series editor Michael S. Greve, who is the John G. Searle Scholar at AEI, is himself a leading thinker and writer as well as an activist in liability-reform circles. The studies presented here aim to be attuned to the strengths as well as deficiencies of our civil liability system, and to address the most serious issues in the policy debates. Some contributions supply much-needed empirical data and analysis, while others tackle the intricate institutional problems of the civil justice system. Above all, the studies aim to contribute fresh ideas and practical reform proposals that are commensurate to the depth and gravity of the problem of unbounded liability.

CHRISTOPHER DEMUTH
President
American Enterprise Institute
for Public Policy Research

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Introduction

Tort awards have increased dramatically in recent decades.[1] Firms avoid producing risky yet useful products like vaccines and small airplanes, and some local communities have stopped providing swimming pools and playgrounds to their residents for fear of lawsuits. Product liability awards and the threat of lawsuits have pushed many companies into bankruptcy, despite improvements in safety.[2] Increases in the number of medical malpractice cases and the size of awards have pushed insurance premiums higher, and doctors have begun leaving hard-hit specialties like obstetrics.[3] Individuals who have never sued anyone in their lives have come to find themselves party to half a dozen cases a year, as consumer class-action suits have multiplied in frequency.[4]

If America has been called "lawsuit hell," contingent-fee lawyers have often been cast as the devils. In the midst of increased filings and escalating awards, it is difficult not to notice that some plaintiffs' lawyers have become very rich. In some cases (prominently, the state cases against tobacco firms), the trial lawyers have collected several billion dollars.[5] The astronomical fees have become the stuff of front-page newspaper coverage and a bestselling novel.[6] The profits earned by an increasingly resourceful, organized, and aggressive "litigation industry," and especially the plowback of those profits into the political system and into evermore creative litigation campaigns, has caused considerable alarm not only (and predictably) among corporate executives, but also among journalists and other observers who are not particularly supportive of corporate defendants.[7]

The trial lawyers' riches per se are not a cause for concern. Americans have a high tolerance for fabulous wealth. Bill Gates and Warren

Buffett are objects of admiration, not envy. However, unlike computer and software production, equity investing, or for that matter movie entertainment (where superstars also earn exorbitant returns), liability litigation is not a productive enterprise. Its central purpose is the redistribution rather than the creation of wealth—sometimes for good but, by all indications, often for ill. The lawyers' fees, both on the defense and plaintiff side, are a pure transaction cost. And as those transaction costs have mounted, the natural suspicion has arisen that the trial bar's fee arrangements may be a driving force behind the liability explosion. Contingent fees have been called unwarranted, and both the fees and the lawyers who accept them have been denounced as unethical and uncivilized.[8] Several prominent observers have argued that contingent fees encourage excessive and frivolous litigation and, moreover, create conflicts of interest between client and attorney, especially with respect to settlement decisions.[9]

These observations and contentions have prompted tort reformers to demand, in addition to substantive legal reforms—such as caps on nonmonetary damages—caps or limitations on contingent fees. A number of states enacted contingent-fee limitations as early as the 1970s and throughout the 1980s (see table 1 on page 16). Reform activity on this front proceeded in tandem with the continued proliferation of high-dollar verdicts. For example, the U.S. Congress considered the imposition of a federal excise tax on "excessive" attorneys' fees, especially the fees collected in connection with the states' antitobacco litigation.[10] Most recently, in November 2004, Florida voters approved a self-executing amendment to the state's constitution which caps attorney fees in medical malpractice cases at 30 percent of the first $250,000 in damages awarded and 10 percent for any award amount above that.

We have considerable sympathy with the general case for tort reform and have submitted some of our reasons and evidence in earlier writings.[11] For reasons explained in this monograph, however, we question the merits of contingent-fee limitations. Those measures have been enacted without any empirical evidence either that contingent fees were responsible for the liability crisis or that limiting them would produce benefits. Based on the evidence presented here,

we are persuaded that restrictions on contingent fees are, for the most part, unjustified. Moreover, they produce unintended negative consequences. Contingent-fee caps or limitations, which operate as a tax on lawyers' compensation, will most likely tend to wash *more* low-value "junk suits" into the legal system.

It is important to note the limitations of this argument. Overwhelmingly, the anecdotal empirical ammunition against contingent fees comes from class actions or mass tort litigation, such as asbestos litigation. Exorbitant attorneys' fee awards in consumer class actions that yield nothing but valueless coupons for the purported plaintiff class have drawn sharp criticism from legal scholars and consumer activists.[12] They have produced interventions by the Federal Trade Commission's Bureau of Consumer Protection and, most recently, federal legislative reform.[13]

Both the extensive literature and the targeted federal interventions, however, illustrate that class actions are a special problem, both as an empirical matter and in terms of the underlying economics. We put those problems aside for one excellent reason: The state contingent-fee limitations here at issue do not apply to class actions or mass torts only. In point of fact, many are targeted at contingent fees in medical malpractice cases, where those forms of actions are exceptionally rare. It is in those traditional, individual suits over medical malpractice and personal injury that contingent-fee limitations, rather than contingent fees themselves, are likely to produce adverse consequences.

We begin by discussing the basic economic theory of contingent fees, which provides potent reasons to believe that such arrangements may be efficient (chapter I). Based on that discussion, we present empirical evidence—discussed in a more extensive and more technical version in an earlier article of ours[14]—showing that contingent-fee limitations tend to increase the frequency of low-value claims (chapter II). Chapters III–V discuss, in light of theoretical considerations and empirical evidence, the most common arguments against contingent fees: the possibility of asymmetric incentives that may induce lawyers to act at variance with their clients' best interests; the charge that contingent fees may generate excess returns (or "rents") for lawyers; and the contention that

contingent fees may be good for the clients (and, for that matter, lawyers) but harmful to society as a whole. We conclude that contingent-fee caps are a poor proxy for better-targeted reforms that would address the true problems of the liability system.

I

Contingent Fees: Economic Fundamentals

We are, as noted, critical of modern tort litigation—and yet cautiously supportive of the contingent-fee arrangements that seem to play such a big role in that industry. Is this not a contradictory position?

The short answer is no. Contingent-fee arrangements are *contracts*, and along with the vast majority of economists, we start with the presumption that self-interest pushes private bargains toward efficiency. The crucial problem in tort law is that there is not enough contract. Theoretically, tort law can be understood as an attempt to mimic contractual considerations: What arrangements would the parties have agreed to if they had been able to contract?[15] Unlike contract law, however, where judges and juries can ground their decisions in actual contracts, tort disputes arise precisely when parties interact without contract. Without the grounding in practice, the decisions of judges and juries may generate inefficiencies.

In short, our skepticism with respect to the tort system and our defense of contingent fees rest on the same general presumption in favor of contract. Restrictions on contingent fees are restrictions on the freedom to contract and, as such, must clear a high hurdle to be justified. The presumption for contracts can be rebutted. But in examining well-accepted contractual practices, one ought to start with the premise of efficiency even when neither the theorists nor, for that matter, market participants themselves can conclusively explain *why* the arrangements are efficient.[16]

Contingent fees *are* a widespread practice. They have been common in the United States for at least a hundred years, long before

onset of the liability crisis.[17] Economic reasons that help explain the practice are not hard to come by.

Reducing Monitoring Costs

Some benefits of contingent fees are well agreed-upon. It is difficult for a plaintiff to evaluate how much effort a lawyer puts into a case. Timesheets are not easily verifiable, and even if they were, hours are not the same as effort. If the plaintiff loses his case, did he lose because his lawyer was ill-prepared? Or was it because the case lacked merit? If the plaintiff wins, would the award have been greater with more effort? A plaintiff who cannot answer these questions will look for some contractual device that promises to induce attorney effort without requiring that the plaintiff be well-informed.

There are several ways of accomplishing that objective. One device is a "conditional fee"—that is, a bonus tied to winning but not to the amount of the award. Thus, an arrangement providing for fees of $1,000 in the event of a loss and $2,000 in the event of a win is a conditional fee. In contrast, a contingent fee ties the lawyer's payment to the outcome of the case on both the winning *and award* dimensions. (The contingent/conditional terminology is not standard, but we think the distinction is useful.) Under a contingent-fee contract, the lawyer receives a percentage of the award, thus providing an incentive to win and to win big. Unlike conditional fees, contingent fees motivate effort on all margins and are therefore more efficient.[18]

Improved Access to the Legal System

A second advantage of contingent fees is improved access to the legal system. Consider what at first seems like a different problem, and imagine that you have a great idea for a new product. Bringing the idea to market will be expensive. You will need to hire engineers, rent office space, enter into distribution agreements, advertise, and so forth, and you are not wealthy.

You might try to borrow money, but a bank is likely to say that your project is too risky, especially given the bank's limited potential profits from the loan. "Come back when you have some customers," says the bank's lending officer. What you need is a venture capitalist who will supply upfront funds in return for a share of your firm. Unlike a bank, the venture capitalist's potential profit is unlimited, which enables him to take significant risks. In addition to funds, the venture capitalist may also bring needed expertise.

A contingent-fee lawyer is, in effect, a venture capitalist of torts. The contingent-fee lawyer combines a claim with funding and expertise to produce a product to be presented to judge and jury. Without venture capital, good ideas would lie dormant. Without contingent fees, good cases would lie dormant.

Risk Spreading

A closely related point is that venture capital and the contingent fee allow entrepreneurs and plaintiffs to spread some of the risk of their projects to others who are better able to absorb it. In the language of general equilibrium theory, the plaintiff pays the contingent fee only in the state of nature in which he is rich, and not in the state of nature in which he is poor. Thus, the contingent fee is a form of insurance. Similarly, the contingent fee has aspects of a loan, since the lawyer makes his investment early but is not paid until later. These features of contingent fees are desirable to the extent that resource or liquidity constraints might otherwise preclude the litigation of meritorious cases.

Signaling Theory

Signaling theory is based on a simple insight: The same contingent fee is more profitable to a high-quality lawyer than to a low-quality lawyer. A lawyer who often wins his cases can afford to offer his services at a contingent fee that would drive a low-quality lawyer out of business. Competition pushes the contingent

fee down to a level where the high-quality lawyers earn a normal profit and the low-quality lawyers exit the industry. A lawyer who offers to take a case based on hourly fees raises suspicion. Why is this lawyer not willing to work on a contingent fee—is it because he knows he is unlikely to win the case? Because lawyers' demands for hourly fees send a negative signal, the contingent fee becomes common.[19]

Admittedly, signaling theory seems to prove too much. Patients are at least as uninformed about physician quality as plaintiffs are uninformed about lawyer quality. Why then are contingent fees uncommon in medical care? One response is to argue that this demonstrates a problem in the financing of medical care.[20] We think it more plausible, however, that what makes contingent fees particularly attractive in law is the insurance aspect—the lawyer is paid only when the plaintiff's wealth increases. In other areas where contingent fees might make sense, moral hazard or signaling-type reasons may prevent the adoption of this payoff structure.[21]

Case Screening

So-called "screening" theory, a close cousin of signaling theory, elaborates on Elihu Root's observation that "about half of the practice of the decent lawyer consists in telling would-be clients that they are damned fools and should stop."[22]

Suppose you approach a plaintiff's lawyer with a potential case, and he politely declines to represent you on a contingent-fee basis. What should you infer? You should infer that the attorney thinks that your case has little chance of winning. Since lawyers are better judges of prospective case outcomes than plaintiffs, this is a useful piece of information. If you cannot get a lawyer to take your case on contingent fee, suing is probably a waste of your time and money.[23]

We should expect contingent-fee lawyers to tell their clients they are fools more often, or at least earlier, than lawyers paid by the hour. Contingent-fee lawyers "screen" potential cases and

clients. In constructing a litigation portfolio for his firm, the lawyer will reject weak cases and agree to handle stronger ones. This screening function is useful both for clients and, most likely, for the legal system at large.

II

Contingent Fees as a Screening Device

It is unlikely that caps and other restrictions on contingent-fee arrangements will simply reduce lawyers' earnings. Rather, the caps or restrictions will operate as a tax. The tax will—like any other tax—prompt dynamic responses, on the part of both lawyers and plaintiffs. These responses may take several forms:

a) Some cases that were profitable for lawyers at a higher contingent fee are no longer profitable at a lower fee. Lawyers now decline these cases.

b) Other cases remain profitable, but, because of the lower fees, the income of plaintiff's lawyers decline.

c) Instead of relying on contingent fees, compensation moves toward an hourly fee model.

The case for contingent-fee restrictions rests on the idea that effects (a) and (b) will occur and, moreover, that they are unambiguously beneficial. The possibility of effect (c) is rarely (if ever) acknowledged. That is a crucial mistake.

Assuming that effects (a) and (b) occur, are they actually desirable? On the extreme assumption that most tort cases do not belong in court, *any* reduction in the number of cases is good. But even under this extreme assumption, effect (a) might be small. The cases that are most likely to fall by the wayside as a result of contingent-fee caps are those with a low probability of winning or a small expected award. By definition, those cases exert only a minor effect

within the system. Thus, we might not expect big gains from effect (a) even if we make the extreme assumption that most cases do not belong in court. On more moderate assumptions, at least some and perhaps many of the cases that lawyers refuse to take are deserving of compensation, meaning that the overall effect of contingent-fee restrictions is not unambiguously positive. Essentially, contingent-fee restrictions would seem a haphazard way to eliminate junk lawsuits, since they are likely also to eliminate meritorious suits.

As for effect (b), while restricting contingent fees may reduce the income of some lawyers, reducing the income of lawyers per se is not a big benefit. So long as large-verdict cases remain profitable, they will continue to be brought. To the extent that the liabilities are excessive, they will have that effect with or without contingent-fee caps. A million-dollar judgment has the same effect on a physician-defendant regardless of whether the lawyer receives 25 percent or 33 percent of the take. It may stick in some people's craw that contingent-fee lawyers earn a lot of money—in the same way that some people are disturbed when pornographers earn a lot of money. But if income taxes were higher, Larry Flynt would still be rich and pornography would still be plentiful.

Effect (c) warns us that restricting contingent fees may not reduce lawyer compensation as much as one might first imagine. As restrictions on contingent fees increase, we can expect that noncontingent, or "hourly fees," as well as other forms of compensation, will become more common.

To illustrate the point, consider a more familiar form of the contingent fee, the restaurant tip. Waiters typically earn a large fraction of their income from contingent fees. Suppose tips were outlawed: what would happen to wages? Waiter income might decline initially, and waiters might even begin to leave waiting for other work; but restaurants would then be forced to raise wages so that on average waiters earned the same with and without tips.

We can expect similar forces to unfold in the legal industry: in the long run, serious restrictions on contingent fees will encourage alternative payment systems. Even today, such alternatives are readily available. Plaintiffs' lawyers use multiple sources of

Exit The Superstars?

Our comparison with waiters' tips suggests that contingent-fee caps *might* serve a useful social function by changing the rewards and professional incentives of the "superstar" lawyers whose astronomical earnings have played a prominent role in calling attention to contingent fees.

If restaurant owners cannot tell who the very best waiters are but customers can, then the very best waiters will do better with compensation from tips than with wage compensation. Analogously, capping contingent fees may not reduce compensation for lawyers on average, but it could cut into the income of the very best plaintiffs' lawyers (unless they can charge for their services in some other manner). As noted, the legal sector of the economy is primarily about redistributing the pie. As the cost of dividing the pie (that is, legal fees and so forth) grow, the value of the pie diminishes—and with it, the incentive to create larger pies. If pie-dividing pays too much, it is even possible to get sucked into a downward spiral of poverty-creation.[24] A well-functioning society, therefore, will seek to ensure that its best and brightest are attracted to professions that create, rather than just redistribute, wealth.

If liability law helped to create optimal deterrence, the incomes of superstar lawyers would be justified on the grounds of economic efficiency—they earn their money by deterring misconduct. But many of the big cases of the recent past—the tobacco, breast implant, and asbestos cases, among many others—have little or no scientific justification and consequently no demonstrable efficiency gains. Thus, to the extent that contingent-fee caps reduce the income of superstar lawyers and thereby encourage them to switch to more productive professions, such caps may prove beneficial.

Although we are not fans of superstar lawyers, we are skeptical that fee limits will push many of them out of the profession. Julia Roberts would still make millions (and still be an actress) even if she never took a cut of the box office receipts. Superstar lawyers would still be superstar lawyers even if contingent fees were capped.

compensation, primarily contingent fees, but also fees for expert witnesses and other trial-preparation costs.[25] Contingent-fee caps would likely produce a shift in that direction.

Perhaps most obviously, the contingent fee could also be replaced by a *conditional fee.* (As explained, a conditional fee is an outcome-dependent form of compensation that is topped off in the event of a win—for example, $0 if the plaintiff loses, $50,000 if he wins.) Conditional fees, which are common in other countries, are not regulated under the current laws limiting contingent fees. Of course, contingent-fee restrictions could be extended to conditional fees. In that event, though, the capitalization and insurance functions of contingent fees would likely be provided by third parties. Some such arrangements, too, already exist. LawCash, for example, lends money to plaintiffs to pay their legal fees or other expenses. The loan is paid off (with a steep fee) only if the plaintiff recovers in a settlement or trial.[26] Similarly, legal insurance will become more common if plaintiffs cannot rely on the contingent fee. Lawyers might even begin to work for fixed fees in legal maintenance organizations, analogous to HMOs.

In short, contingent-fee arrangements are common because they bundle various functions that are useful for both lawyers and plaintiffs. Contingent-fee caps will, at the limit and in the long run, force an unbundling of those functions. There is no reason to believe that the resulting industry structures will be more efficient than contingent fees. Currently, for example, third-party loans and legal insurance operate largely as backstops to the prevailing contingent-fee practice, which suggests that they are *less* desirable.

At the same time, the proposed caps threaten to compromise the screening function of contingent fees by pushing parties into substituting the most obvious financing alternative—the hourly fee. The screening theory suggests that as lawyers increase their reliance on hourly fees, they will be more willing to take weaker cases. Why not, when the client is paying by the hour? This prediction is sufficiently important to merit empirical examination.

In principle, one could examine whether cases taken under the hourly fee win less often than cases taken under the contingent

fee. The difficulty with this procedure, however, is that cases taken to trial are not a random sample of all cases.[27] The nonrandom character of trials makes it questionable to look at win rates directly. For that reason, we have tested in our earlier work a related implication of the screening theory. As time passes and cases taken under the hourly fee move through the legal system, clients gain information. Some with weak cases, having learned what a contingent-fee lawyer would have told them on day one, realize they are unlikely to win and drop their cases—wiser but poorer.

We tested this hypothesis through an analysis of case outcomes in various states with *and without* contingent-fee caps, in different classes of cases. We drew our data from the Civil Justice Survey of State Courts, 1992, a survey of litigation conducted by the U.S. Department of Justice and the Bureau of Justice Statistics.[28] At the time covered by the survey data, sixteen states limited the contingent fees lawyers could charge in medical malpractice cases.[29] Of the sixteen states with such limits, ten had counties in the state court dataset. Two, Florida and Michigan, limited contingent fees in all personal injury cases, which made it difficult to create an in-state control group. Therefore, we dropped Florida and Michigan from the analysis. That left us with eight "hourly fee" states—that is, states with limits on contingent fees in medical malpractice cases but not in auto cases. These were California, Connecticut, Illinois, Indiana, Massachusetts, New Jersey, New York, and Wisconsin. The eight "contingent-fee" states—states without limits in any class of cases—were Georgia, Kentucky, Minnesota, Missouri, Ohio, Pennsylvania, Texas, and Virginia. Table 1 shows the distribution.

The adoption of contingent-fee caps in selected states allowed us to examine data on a sample of tort cases to test whether clients dropped their cases more often there. As a first step, we examined exclusively medical malpractice cases. Table 2 shows that in states without limits on contingent fees, just under 5 percent of medical malpractice cases were dropped. In contrast, in states *with* limits, a whopping 18 percent of cases were dropped.

States with and without limits on contingent fees might differ in ways other than limits. To test whether other factors accounted

for the difference in drop rates, we took advantage of the many states that restricted contingent fees in medical malpractice cases but not in other types of cases. Applying this "difference-in-difference" analysis, we found that drop rates in automobile cases were nearly identical in states that did and did not restrict contingent fees in medical malpractice cases (9.7 percent versus 10.2 percent). Thus, across the same set of states, there were big differences in drop rates in cases where contingent fees were limited, but no such differences in cases with no restrictions.

In our earlier work, we further controlled for a variety of other variables, such as the type of defendant, the type of plaintiff claim, and caps on punitive damages. The same difference-in-difference technique used in a probit model yielded results very similar to those of the simpler test presented here.

The test in table 2 used data from across the states during the same period of time. A complementary test used data from the same state at different points in time. Florida limited contingent fees in medical malpractice cases in November of 1985. We therefore looked at drop rates before and after November of 1985. The shorter the "before" and "after" periods examined, the more confident we can be that other factors remained the same. Accordingly, we compared the drop rate of cases filed three hundred days before limits were imposed with the drop rate of those filed three hundred days after limits. Table 3 shows the results.[30]

Once again, we found that drop rates increased after contingent fees were restricted. The increase in drops was three and a half percentage points, or approximately a 15 percent increase. While the increase in drops was smaller than that observed in the cross-state regressions, recall that the increase here occurred within less than a year from the time contingent fee limits were imposed.

Our results provide indirect evidence for our contention that contingent-fee restrictions may erode the screening function of such arrangements and increase the proportion of low-value suits within the system.

TABLE 1
CONTINGENCY FEE LIMITS BY STATE

State	Limits
California	40% of first $50,000; 33⅓% of the next $50,000; 25% of the next $500,000; 15% of damages that exceed $600,000
Connecticut	33⅓% of first $300,000; 25% of the next $300,000; 20% of the next $300,000; 15% of the next $300,000; 10% of the next $300,000
Delaware	Unclear
Florida	33⅓% of any recovery up to $1 million through the time of filing of an answer or the demand for appointment of arbitrators; 40% of any recovery up to $1 million through the trial of the case; 30% of any recovery between $1 million and $2 million; 20% of any recovery in excess of $2 million[a]
Illinois	33⅓% of the first $150,000; 25% of the next $850,000; 20% of amounts over $1,000,000
Indiana	15% of any recovery from the compensation fund
Maine	33⅓% of the first $100,000; 25% of the next $100,000; 20% of amounts over $200,000
Massachusetts	40% of the first $150,000: 33⅓% of the next $150,000; 30% of the next $200,000; 25% of any amount over %500,000
Michigan	33⅓% of any award
New Jersey	33⅓% of the first $250,000; 25% of the next $250,000; 20% of the next $500,000; if the award exceeds $1,000,000 the attorney must apply to the assignment judge for a higher fee
New York	30% of the first $250,000; 25% of the next $250,000; 20% of the next $500,000; 15% of the next $250,000; 10% of any amount over $1,250,000
Oklahoma	50% of any award
Oregon	33⅓% of the total amount received but no more than 20% of punitive damages
Tennessee	33⅓% with court review
Utah	33⅓% of all awards
Wisconsin	33⅓% of the first $250,000; 25% of the first $1,000,000 depending when the case is settled; 20% of over $1,000,000

SOURCE: Compiled from Nancy Brannon, *Tort Reform Compendium* (Chicago: American Medical Association, 1997).
a. Computed only if in state court data.

Effective Dates	Actions to Which Limits Apply	In State Court Data?
1975	Medical malpractice	Yes
1986	Medical malpractice	Yes
1976	Medical malpractice	No
1985 (Nov.)	Medical malpractice cases (extended to all personal injury cases in 1986)	Yes
1985	Medical malpractice	Yes
1975	Workers compensation	Yes
1986	Medical malpractice	No
1986		Yes
1981	All personal injury cases	Yes
1976	All personal injury cases	Yes
1976	Medical malpractice	Yes
1953	All personal injury cases	No
1995	Medical malpractice	No
1975	Medical malpractice	No
1985	Medical malpractice	No
1986	Medical malpractice	Yes

TABLE 2

PROPORTION OF DROPPED CASES IN LIMIT AND NO-LIMIT STATES (State court data)

		Total Cases	Dropped Cases	Proportion
States with limits on contingent fees (hourly fee states)	Medical malpractice	454	83	18.3%[a]
	Auto	4,838	468	9.7%
Nonlimit states	Medical malpractice	287	14	4.9%[a]
	Auto	3,474	353	10.2%

SOURCE: Authors' calculations.
a. The difference between these two percentages is statistically significant at the greater than 1% level.

TABLE 3

PROPORTION OF DROPPED CASES PRE- AND POST-1985 LIMIT (Florida data)

Period	Total Cases	Dropped Cases	Proportion
Pre-limit (1985)	1,938	440	22.7%[a]
Post-limit (1985–86)	1,064	279	26.2%[a]

SOURCE: Authors' calculations.
a. Difference is statistically significant at the 5% level.

III

Asymmetric Incentives?

Contingent fees are often said to drive a wedge between client and lawyer interests when it comes to settling a case. Asymmetric incentives supposedly affect settlement rates and values, as well as time to settlement. These assertions are difficult to refute or confirm. Economic models of the settlement process are highly sensitive to their underlying assumptions, and empirical studies are sparse and inconclusive. Our own studies have found no evidence that contingent fees affect settlement rates one way or the other. We have, however, found evidence that they reduce the time to settlement.

Settlement Rates

The basic argument is that under a contingent fee, the lawyer bears all the costs of litigation but receives only a fraction of the benefits. On the margin, then, the lawyer has a greater incentive to settle than the client.[31] At the outset, it is important to put this (perceived or real) asymmetry and its potential effects in context. At a split of two-thirds of the settlement for the client and one-third for the lawyer, the plaintiff's interest and the lawyer's interest differ by only a factor of two, far smaller than in other contexts where contingent fees are common, such as in real estate where the seller's agent typically receives only 3 percent or less of any increase in the sales price.

More important, one must avoid what Harold Demsetz called the nirvana fallacy.[32] A comparison of the actual to the ideal is bound to be unflattering to the actual. The relevant alternative to the contingent fee is not the "efficient solution," as found in an

economic model with complete information. The relevant alternative is the hourly fee (or perhaps the less often used flat fee). Under the hourly fee, the lawyer has too little incentive to settle—after all, settling means the end of payment. And, as noted above, a lawyer is likely to make less effort under the hourly fee. Compared to that massive asymmetry of incentives (and the exorbitant monitoring costs required to curtail its effects), the divergence of interests under contingent fees is bound to be limited.

It is also unclear which way those asymmetries cut. The argument that under-incentivized lawyers will "sell out" their clients assumes that the lawyer has control over settlement. If control over settlement remains with the client, it is easy to turn the argument around. Under contingent fees, the client is less interested in settling than under hourly fees, because the costs of trial are born principally by the lawyer. Moreover, knowing that plaintiffs face little of the cost of going to trial can encourage defendants to settle. Thus, the net effect on settlement is not obvious.

Even if we assume that the lawyers have considerable control over whether to settle, reputation and the demand for repeat business will induce them to settle as their clients would wish. Lawyers do not want to have a reputation for settling too easily, and they do want to have a reputation for producing good results for their clients. Repeat business and business from friends and family are important for most lawyers.[33]

Finally, clients have a number of means available to motivate lawyers to settle optimally. If the lawyer has too great an incentive to settle, for example, then it's a simple matter to raise the contingent fee if the case goes to trial (for example, 25 percent if settled before trial, 33 percent if the case goes to trial). Alternatively, if the problem is that the lawyer bears all the costs but receives only a fraction of the benefits, a solution is for the client to bear some of the costs. If the lawyer reaps one-third of the benefits and bears one-third of the burden, for example, then his incentive to settle will be exactly the same as his client's. Such a scheme would usually require payment of some upfront costs on the part of the client (although modifications can eliminate this necessity, too).[34] While

financing plans of this sort are rarely explicit, it is not uncommon for clients to bear some of the costs of prosecuting a case.[35] It should be noted, however, that such a situation can lead to abuse.

Empirical evidence of the effect of contingent fees on settlement rates is quite limited. An ideal study would compare outcomes of cases that were randomly assigned to contingent or hourly fee lawyers. No such study exists, however, and only a few (and now somewhat dated) studies have examined the question at all:

- In a 1991 study, Terry Thomason found that plaintiffs who hire lawyers had higher settlement rates and lower settlement amounts than those who represented themselves. Because lawyers in these cases were paid at least some of their compensation from a contingent-fee arrangement, Thomason concluded that contingent fees *increased* settlement rates and *reduced* settlement amounts.[36] Two factors suggest caution before accepting these conclusions. First, self-selection is potentially an important factor when some plaintiffs choose to hire lawyers and others do not. If plaintiffs who hire lawyers have weaker cases (a plausible assumption), we might expect settlement rates in this group to be higher and settlement amounts to be lower. Second, even assuming that selection effects are absent, Thomason could not distinguish whether the effects he found were due to representation by lawyers or to lawyer fee arrangements.

- More evidence on the impact of contingent fees is found in Patricia Danzon and Lee Lillard's model of dispute resolution. Although contingent fees were not the focus of their investigation, Danzon and Lillard estimated the effect of restricting them on settlement rates. (Their data covered 1974 and 1976, allowing them to pick up a number of changes in the law that occurred in 1975.)

They found that restrictions on contingent fees were associated with an *increase* of one and a half percentage points in the settlement rate.[37]

- From a survey of lawyers, Douglas Cumming found that disputes over settlement between lawyer and client occurred *less* often when the lawyer charged using a contingent fee.[38] One has to be wary of survey results on disputes, as lawyers may not wish to advertise how many they have had. Still, the result is inconsistent with the notion that contingent fees separate the interests of lawyer and client.

Thus, the existing research, including our own, has not provided robust, clear-cut results regarding the effect of contingency fees on settlement rates.

Time to Settlement

Changing the time to settlement is different from changing the probability of settlement. Longer times, for example, could be associated with higher or lower probabilities of settlement. Longer times to settlement could be associated with a higher probability of settlement if, for example, extra time allows for more settlements; longer times could be associated with lower probabilities if, for example, the extended time bumps more cases against the trial date.

Contingent fees have been accused of both slowing down and speeding up the time to settlement. In an influential critique, for example, Walter Olson has argued that

> 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.[39]

On the other hand, David Bernstein has claimed that "because time is most definitely money in the legal business, it pays the contingent-fee attorney to settle as quickly as possible."[40]

We suspect that the latter theory is more likely to be correct on average. An hourly fee lawyer has a greater incentive to rack up hours than one on contingent fee, and this will tend to lengthen the time to settlement. (This is *not* true by definition; it is easy to delay settling a case without working many hours.) Thus, when contingent fees are restricted and a higher proportion of lawyer remuneration comes from hourly fees, we expect that cases will take longer to be settled. Of course, an hourly fee lawyer will not be paid for pure delay, but by spending more time on discovery, searching for legal precedents, beginning with unattractive settlement bids, and encouraging clients to refuse early settlement offers, a lawyer can increase both the time to settlement *and* billable hours.

Using the state court and Florida datasets described earlier, we estimated the effect of restricting contingent fees on the expected time until settlement. As before, we took into account other factors, using automobile accident cases as a control. (We also used a number of other control variables under a censored Tobit regression on the log of settlement time.[41]) In the state court data, we found that restricting contingent fees increased the time to settlement by 22 percent. Similarly, we found that in the thirteen months after contingent fees were restricted in medical malpractice cases in Florida, the time to settlement increased by 13 percent.

Thus, we found little evidence that contingent fees markedly increased settlement rates. We did find that restrictions on contingent fees increased both the time to settlement and the number of cases plaintiffs wasted time filing before eventually dropping them.

IV

Do Contingent Fees Yield Excess Returns to Lawyers?

If contingent fees are part of an optimum plaintiff–lawyer client contract, why do contingent-fee lawyers seem to earn "excessive" returns? For example, Lester Brickman, a leading critic of contingent fees, has claimed that

> 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.[42]

Certainly, one can find examples of very high payments to contingent-fee lawyers. Most of these, however, involve either class actions or cases that are altogether sui generis. As mentioned earlier, in 1998 a group of lawyers was awarded over 8.2 *billion* dollars in fees for representing Florida, Mississippi, and Texas in their suits against tobacco companies to recover health-care expenses. All told, the state settlements generated somewhere between 18 and 38 billion dollars in fees, equivalent to tens of thousands of dollars per hour in compensation for each lawyer involved. But while the fees in the tobacco deal have become a mainstay of contingent-fee critics, that deal was less a settlement of a legal case than a political bargain among the tobacco companies,

the state governments, and the lawyers, all of whom gained at the expense of an unrepresented group, the smokers. The fees were shocking; but then, so was the tobacco deal itself. Lower fees would hardly have made the deal more reasonable.

Similarly, contingent fees in class actions are by no means representative of all lawyer–client contracts. Plaintiffs in class actions often do not even know a suit is being brought on their behalf.[43] Judicial review of these settlements is required because plaintiffs have little incentive to monitor "their" attorneys.[44]

To evaluate the fees in contingent-fee cases, we need to look at more run-of-the-mill cases. Here, little if any empirical evidence buttresses the contention that contingent-fee lawyers earn above-normal returns, and standard economic theory provides potent reasons for skepticism that such returns could be sustained for any length of time.

Contingent Fees, *Ex Ante* and *Ex Post*

In part, the outrage over contingent fees represents a case of mistaking that which is seen for all that there is. After a case has been settled or concluded, contingent fees may appear large relative to the number of hours a lawyer has put into that particular case. But the fee needs to be evaluated *ex ante*—that is, before the case begins. By way of a simple example, assume that there is a 50 percent probability a case will be won and, if won, a certainty that damages will be equal to $15,000. Assume that the contingent fee is set at one-third, and that the lawyer puts ten hours of work into the case. If the case is won, the lawyer receives $5,000, or $500 per hour—quite a high hourly fee. But recall that the case only wins one-half of the time. The other half of the time the lawyer receives nothing, so the expected hourly fee is not $500, but $250 (not bad, but that is before expenses). More generally, if the appropriate hourly fee is $X per hour, we can expect the equivalent hourly fee calculated from winnings to be $X/p, where p is the probability of winning. If the probability of winning is 50 percent, we can expect

the equivalent hourly fee in contingent-fee cases to be twice as high as a regular hourly fee. If the case is particularly unlikely to succeed, the equivalent hourly fee may be much higher.

Most cases are settled rather than tried, but the same principle applies when we consider that settlement amounts are uncertain. Assume that the damages in a given case are uncertain—say, a 50 percent probability of $25,000 and a 50 percent probability of $5,000. In some winning cases, the equivalent hourly fee will be $833, but in others just $166. The expected equivalent hourly fee is identical to that found earlier. *Ex post*, it will appear that in some cases the fees were exorbitant. Yet we know that the *ex ante* fee was reasonable. Add into the mix some small probabilities of very large awards, and it is easy to see how equivalent hourly fees may appear huge even when expected hourly fees do not depart greatly from regular hourly fees. Recall our earlier analogy to venture capitalists. It is common to hear about venture capitalists who multiply their investments ten or even a hundred times, but those huge returns are paralleled by many investments that return little or nothing.

Equivalence or Collusion?

As we have seen, Brickman has claimed that even in ordinary cases, contingent-fee lawyers earn excessive and unjustifiable returns. But Brickman's evidence was primarily anecdotal and is contradicted by more substantial data (see below). The argument that contingent-fee lawyers are earning substantial excess returns is also inconsistent with basic economic theory and the fact of extensive competition in the market for lawyers. If contingent-fee lawyers were "not infrequently" earning thousands or tens of thousands of dollars an hour, they would be earning far more than hourly fee lawyers—that is, defense lawyers and corporate lawyers. That seems highly unlikely. Plaintiff and defense lawyers have very similar amounts of education and skill, so we would expect them to have similar earnings. If contingent-fee lawyers were earning markedly higher fees than defense lawyers, the

defense lawyers would switch practice until earnings were equalized. In short, we expect to see roughly equivalent returns for hourly and contingent-fee lawyers, with some adjustments being made for insurance and interest payments and due allowance being made for a handful of contingent-fee superstars.

Empirical evidence is consistent with these expectations. Herbert Kritzer surveyed Wisconsin lawyers and found a median hourly fee of $125 and an equivalent hourly fee for those on contingent fee of $132. As expected, a handful of cases from a handful of lawyers were very profitable on an hourly basis, so mean figures showed larger differences, with a mean hourly fee of $124 and an equivalent hourly fee of $242. Kritzer found similar ranges in a dataset of federal cases.[45]

Due to the difficulties of measuring and controlling for factors such as case type, quality of lawyer, hours, insurance, and interest payments, we should not put too much weight on these precise findings. Certainly, however, the data have provided no evidence of "abuse" or "extortionate" practices in contingent-fee pricing. They have been fully consistent with the roughly equivalent returns predicted by economic reasoning.

Brickman has argued that contingent-fee lawyers collude to maintain fees.[46] While it is certainly true that due to restrictions on entry the market for lawyers is not fully competitive, those barriers work to raise the earnings of *all* lawyers. It is one thing to claim that lawyers earn more because they have managed to exclude competition from paralegals. It is quite another to assert that one type of lawyer earns more than other types, despite the fact that no entry barrier prevents a lawyer from changing his pricing scheme at the drop of a hat.

In support of a collusion theory, Brickman and others have observed and inveighed against the fact that the same contingent fee applies to a big case as to a small one.[47] The suggestion here is that time and effort do not rise in direct proportion to the "size" of a case. If a one-third contingent fee for small cases is competitive, then—the argument runs—the same fee for a big case must be supracompetitive, and the prevalence of that fee structure must be

due to collusion. But that is a non sequitur. While it is possible (though difficult) to believe that the market for lawyers is uncompetitive, we observe very similar pricing and compensation patterns in markets that are clearly and almost pristinely competitive.

Again, it is useful to compare contingent fees in law with contingent fees for waiters. Here, the same 15–20 percent tip applies to expensive restaurants as to cheap ones. It is unlikely in the extreme, however, that waiters collude to maintain tip percentages, or that those at expensive restaurants rip the customers off. A more likely explanation is that waiters at expensive restaurants are better waiters. (One interesting piece of evidence in support of this theory is that waiters at expensive restaurants are typically paid higher wages *in addition* to earning far more in tips.) For analogous reasons, high-quality lawyers will be in a better position than less-qualified lawyers to assemble a portfolio of high-value cases with better-than-average chances of prevailing. The uniformity of contingent-fee arrangements *in percentage terms* is more likely to reflect these demand-driven dynamics than collusion.

V

Contingent Fees and the Social Interest

Clients watch out for their own interests. Of course, not all clients are capable of guarding their interests well in every transaction. But as in other markets, competition is the consumer's best friend, and lawyers do sell their services in competitive markets. Claims that the contingent fee harms the interests of clients therefore should be regarded with some suspicion, at least to the extent of requiring strong evidence. We have found no such strong evidence. On the contrary, we have found evidence that restrictions on contingent fees contribute to wasted plaintiff effort (as evidenced by dropped cases) and longer times to settlement.

Contingent fees, however, may harm social interests even as they contribute to plaintiff interests. We have good grounds for thinking that competition promotes the interests of buyers, but competition alone is no guarantee that the interests of society will be promoted. After all, competition among hit-men benefits the buyers of their services, but not society. Walter Olson made this argument for contingent fees:

> The case against the contingent 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. . . . Giving soldiers

> contingent fees for successful attacks, by letting them loot the town they capture, was long favored as a way of encouraging warlike zeal but came under gradual ethical control as civilization progressed . . . Giving lawyers contingent fees encourages similar abuses of both the client and the public.[48]

It's worth mentioning that the Olson thesis runs counter to Brickman's theory of contingent fees as a conspiracy against the client. We offer a rough test of the thesis—using data from the 1992 Civil Justice Survey of State Courts, we examined whether awards were lower where contingent fees were restricted. The raw data show the exact opposite result to that hypothesized by opponents of contingent fees. We found that awards in the states that limited contingent fees were more than twice as high as in those without restrictions. The results are shown in table 4.

We caution, however, that the data need to be taken with several grains of salt. We did not control for other factors that might have accounted for differences across the states. A simple first step was to examine automobile accident awards in these same states. Again, the results appear in table 4. They show that awards were also higher in auto cases (which were not limited) in states that limited contingent fees in medical malpractice cases, but the difference in awards remained large even after taking this into account. That is, malpractice awards and automobile awards are both higher in states that restrict contingency fees in malpractice cases, but relative to states without restrictions malpractice awards are especially high.

That result, to repeat, should not be overinterpreted. We have taken no account of "reverse causality"—that is, of the possibility that states with large medical malpractice awards are more likely to pass limits on contingent fees than other states—and of other complicating and confounding factors. A more thorough analysis must await another day. Our purpose in presenting the data is simply to make the prima facie argument that restricting contingent fees does not greatly reduce awards.

TABLE 4

RESTRICTIONS ON CONTINGENT FEES DO NOT APPEAR TO REDUCE AWARDS IN MEDICAL MALPRACTICE CASES

	Mean Award	**Observations**
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

SOURCE: Data from the Civil Justice Survey of State Courts, 1992.

Conclusion: Tort Reform by Proxy?

Common criticism of contingent fees is that they promote "excessive," "speculative," or "frivolous" litigation, to use three terms found in the literature. Bernstein, for example, writes that the contingent fee "encourages attorneys to engage in speculative litigation in the hope of landing the occasional large jackpot."[49] Our findings on contingent fees and dropped cases, however, indicate that it is the hourly fee that encourages attorneys to bring frivolous litigation—that is, cases that are unlikely to win.

More generally, many tort reforms have been motivated by the view that contingent fees increase the number of cases that do not belong in the courts. The exact reasoning behind this claim is not always clear. Two ideas need to be distinguished. If contingent fees help plaintiffs overcome risk-aversion or capital constraints, one would expect contingent fees to increase the *amount* of litigation. Critics of contingent fees tend to be critics of the tort system in general, so this effect alone is enough to make them condemn contingent fees. But if the problem to be solved is too many cases in the courts, then the appropriate solution is a congestion fee. Why interfere in the contracting of plaintiffs and lawyers, reducing their opportunities for risk-sharing and borrowing, when a more direct solution is possible? Alternatively, perhaps the problem is that awards are too high or are granted in cases where they should not be granted. There is mounting evidence that this is the case. The tort system in 2003 comprised an

estimated 2.23 percent of the United States' gross domestic product (GDP).[50]

Yet this vast and expensive system is not particularly accurate. For example, a Harvard study of New York hospitalization injuries (resulting from hospitalizations in 1984) found that most malpractice claims did not involve medical negligence.[51] The results were similar in a study covering Utah and Colorado hospitalizations in 1992.[52] Viewed this way, one might argue that if most cases are without merit, any reform that reduces the case volume is an improvement.

However, the studies also found that 3–4 percent of hospitalizations appear to give rise to adverse events (such as drug reactions), and that approximately a third to one-half of these adverse events are due to negligent actions. In short, few injured people sue, and relatively few suits involve injured people. The problem is not how lawyers are paid, but that the court system does not do a good job of screening meritless cases.

Blaming contingent fees for out-of-control courts is like blaming credit cards for personal bankruptcy. While there may be some connection between credit cards and bankruptcy, it is easy enough to go bankrupt without a credit card, and there are so many benefits of credit cards that we would not want to discourage their use.[53] Similarly, the connection between contingent fees and out-of-control courts may not be zero, but restricting contingent fees is a poor way of reining in the courts. The evidence from the studies of medical malpractice strongly suggests that reforms should aim at improving the judicial screen against meritless cases.

Contingent fees have a number of benefits, such as helping to motivate lawyers even when clients find it difficult to monitor their efforts. Contingent fees also force lawyers to be honest with their clients about the quality of the client's case. A contingent-fee lawyer will not take on a case that he expects to lose. As a result, we hypothesized, restrictions on contingent fees would increase, not decrease, the number of low-quality suits as hourly fee lawyers took on cases that contingent-fee lawyers would reject. Using

drops as a measure of quality, we found that clients dropped their cases much more often when contingent fees were limited. The result was robust. We found that restrictions on contingent fees increased drops using two different datasets, one that examined differences across the states at a single point in time and another that looked at a single state through time. In both analyses, we were able to use differences in automobile cases, where contingent fees were not limited, as control cases.

Contingent-fee restrictions appear to be a blunt and ineffective way to reform the tort system. As discussed here, there is very little evidence that such restrictions eliminate a substantial proportion of frivolous lawsuits, and theory, along with some empirical evidence, suggests that limiting contingent fees actually increases a plaintiff attorney's incentives to pursue low-quality cases. Supporters of tort reform would be better served by pursuing other avenues which have more potential to improve social welfare.

Notes

1. Eric Helland, Jonathan Klick, and Alexander Tabarrok, “Data Watch: Tort-Uring the Data,” *Journal of Economic Perspectives* 19, no. 2 (2005): 207– 220.

2. See, for example, George Priest, “The Modern Expansion of Tort Liability: Its Sources, Its Effects, and Its Reform,” *Journal of Economic Perspectives* 5, no. 3 (1991): 31–50.

3. U.S. Department of Health and Human Services, *Confronting the New Health Care Crisis: Improving Health Care Quality and Lowering Costs by Fixing Our Medical Liability System* (Washington, D.C., 2002), 2–3, 12–13, http://aspe.hhs.gov/daltcp/reports/litrefm.pdf (accessed June 2, 2005).

4. Deborah R. Hensler, “Revisiting the Monster: New Myths and Realities of Class Action and Other Large Scale Litigation,” *Duke Journal of Comparative and International Law* 11, no. 2 (2001): 179–214.

5. Perhaps due to the uproar over the first announcement, the attorneys general, the tobacco companies, and the lawyers have kept the exact fees secret; Kip Viscusi, *Smoke-Filled Rooms: A Postmortem on the Tobacco Deal* (Chicago: University of Chicago Press, 2002), 4. Robert Levy calculates that the fee in the Florida, Mississippi, and Texas case was equivalent to over $14,000 an hour, assuming twelve hours of work a day, seven days a week for forty-two months. See Robert Levy, “Hired Guns Corral Contingent Fee Bonanza,” *Legal Times*, February 1, 1999, 27. See also Lester Brickman, “Effective Hourly Rates of Contingency Fee Lawyers: Competing Data and Non-Competitive Fees,” *Washington Law Quarterly* 81, no. 3 (2003): 653, 660 n13. Brickman cites equivalent hourly fees in the hundreds of thousands of dollars once hours are estimated realistically.

6. Monica Langley, “Bayer, Pressed to Settle a Flood of Suits Over Drug, Fights Back,” *Wall Street Journal*, May 3, 2004, A1; John Grisham, *The King of Torts* (New York: Doubleday Books, 2003).

7. See Christopher Schroeder, “The Multistate Settlement Agreement and the Problem of Social Regulation Beyond the Power of State Government,” *Seton Hall Law Review* 31 (2001): 612–16; Ralph Thomas and Andrew Garber, “Out-of-State Donors Feed Gregoire Fund,” *Seattle Times*, October 28, 2004, http://seattletimes.nwsource.com/html/localnews/2002074950_gregoire28m.html (accessed June 2, 2005); Skip Hollandsworth, “The Lawsuit from Hell,” *Texas Monthly*, June 1996, 106.

8. See Brickman, “Effective Hourly Rates of Contingency Fee Lawyers,” 653–60; and Walter Olson, “Sue City: The Case Against the Contingency Fee,” *Policy Review*, Winter 1991, http://walterolson.com/articles/conting cy1.html (accessed June 2, 2005).

9. See F. B. MacKinnon, *Contingency Fees for Legal Services* (Chicago: American Bar Association, 1964); Geoffrey Miller, “Some Agency Problems in Settlement,” *Journal of Legal Studies* 16 (1987): 189–215; and D. E. Bernstein, “Procedural Tort Reform: Lessons from Other Nations,” *Regulation*, http://www.cato.org/pubs/regulation/reg19n1e.html (accessed June 2, 2005). Also see Walter Olson, *The Litigation Explosion* (New York: Truman Talley Books, 1991).

10. *Intermediate Sanctions Compensatory Revenue Adjustment Act of 2003*, 108th Cong., 1st sess., S. 887 (HR 1926).

11. See, for example, Eric Helland and Alexander Tabarrok, “The Effect of Electoral Institutions on Tort Awards,” *American Law and Economics Review* 4, no. 2 (1999): 341–70; and Eric Helland and Alex Tabarrok, “Race, Poverty, and American Tort Awards: Evidence from Three Datasets,” *Journal of Legal Studies* 32, no. 2 (2003): 27–58.

12. See, for example, *Public Citizen Litigation Group Quarterly Update*, July 28, 2000, http://www.citizen.org/litigation/about/articles.cfm?ID=554; last accessed June 20, 2005. Walter E. Dellinger, III, Testimony before the Senate Committee on the Judiciary, *Class Action Litigation*, 107th Cong., 2d sess., July 31, 2002.

13. U.S. Federal Trade Commission, “Announced Actions for June 6, 2003,” press release, June 6, 2003, http://www.ftc.gov/opa/2003/06/fyi 0336.htm (accessed June 2, 2005); U.S. Federal Trade Commission, “Announced Actions for March 17, 2004,” press release, http://www.ftc.gov/opa/2004/03/fyi0419.htm (accessed June 2, 2005); *Class Action Fairness Act of 2005*, Public Law 109–2, 109th Cong., 1st sess., February 18, 2005.

14. Eric Helland and Alexander Tabarrok, “Contingency Fees, Settlement Delay, and Low-Quality Litigation: Empirical Evidence from Two Datasets,” *Journal of Law, Economics and Organization* 19 (2003): 517–42.

15. Paul Rubin, *Tort Law by Contract* (Washington, D.C.: AEI Press, 1993).

16. Frank Easterbrook, "The Limits of Antitrust," *Texas Law Review* 63 (1984): 9–10.

17. It is slightly puzzling, however, that contingent fees are virtually unheard of in legal systems outside the United States. Perhaps this has to do with cultural idiosyncrasies, such as the more entrepreneur-friendly climate in the United States, as opposed to any particular beliefs about the effects of contingent fees. Analogously, Robert Gordon points out that the use of venture capital is far more widespread in the United States than it is in the rest of the world; see Robert Gordon, "Why Was Europe Left at the Station When America's Productivity Locomotive Departed?" (National Bureau of Economic Research, Working Paper No. 10661, 2004). Another potential puzzle arises regarding the fact that contingency fees are generally barred in criminal law cases and family law cases. Perhaps these restrictions stem from valuation problems (for example, how can an acquittal be valued in a reasonable way to generate a basis on which to apply the contingency fee?). Research on these questions would be very valuable.

18. For an analysis see Winand Emons and Nuno M. Garoupa, "The Economics of US-Style Contingent Fees and UK-Style Conditional Fees" (Center for Economic and Policy Research, Discussion Paper No. 4473, July 23, 2004), http://www.cepr.org/pubs/dps/DP4473.asp (accessed April 27, 2005). For more on contingent fees as a device to increase effort see Murray L. Schwartz and Daniel J. B. Mitchell, "An Economic Analysis of the Contingency Fee in Personal-Injury Litigation," *Stanford Law Review* 22 (1970): 1125–62; Patricia M. Danzon, "Contingency Fees for Personal Injury Litigation," *Bell Journal of Economics* 14 (1983): 213–24; and Bruce L. Hay, "Contingency Fees and Agency Costs," *Journal of Legal Studies* 23 (1996): 503–33. In Herbert M. Kritzer, "Seven Dogged Myths Concerning Contingency Fees," *Washington University Law Quarterly* 80 (2002): 739–84, the author argues that contingent fees seem common in other countries, but upon close inspection many of these turn out to be conditional rather than contingent fees.

19. See Daniel L. Rubinfeld and Suzanne Scotchmer, "Contingency Fees for Attorneys: An Economic Analysis," *RAND Journal of Economics* 24 (1993): 343–57. The signaling model can be modified in a variety of ways. Instead of the signal being sent by the lawyer, for example, one can model a situation where clients use the contingent fee to signal the strength of their case. Other variants are also possible. Papers in the signaling literature include Janet K. Smith and Steven R. Cox, "The Pricing of Legal Services: A

Contractual Solution to the Problem of Bilateral Opportunism," *Journal of Legal Studies* 14 (1958): 167–83; James D. Dana and Kathryn E. Spier, "Expertise and Contingency Fees: The Role of Asymmetric Information in Attorney Compensation," *Journal of Law, Economics and Organization* 9 (1993): 349–67; and Neil Rickman, "Contingency Fees and Litigation Settlement," *International Review of Law and Economics* 19 (1999): 295–317. For a good survey of these and other issues see Daniel L. Rubinfeld and Suzanne Scotchmer, in *New Palgrave Dictionary of Economics and the Law*, ed. Peter Newman (New York: Macmillan Press, 1998), s.v. "contingent fees."

20. For a good argument along these lines see David A. Hyman and Charles Silver, "You Get What You Pay For: Result-Based Compensation for Health Care," *Washington and Lee Law Review* 58 (2001): 1427–90.

21. Robin Hanson has provided a strong argument for the value of compensating doctors on a contingent basis. One potentially relevant difference between medicine and law is the widespread use of health insurance (especially managed-care systems), which dampens some of the benefits of a contingent-fee system. Perhaps in a fee-for-service health system, we might observe more contingent fees for doctors. See Robin Hanson, "Buy Health, Not Health Care," *Cato Journal* 14, no. 1 (1994): 135–41.

22. Quoted in Mary Ann Glendon, *A Nation under Lawyers* (New York: Farrar, Straus and Giroux, 1994), 37.

23. Judge Richard Posner used this argument in several dissents from decisions appointing counsel for prisoners in civil rights suits. See *McKeever v. Israel*, 689 F.2d 1315, 1324–25 (7th Cir. 1982), and *Merritt v. Faulkner*, 697 F. 2d 761, 769–770 (7th Cir. 1983).

24. William Baumol, "Entrepreneurship: Productive, Unproductive and Destructive," *Journal of Political Economy* 98, no. 5 (1990): 915.

25. Douglas Cumming, "Settlement Disputes: Evidence from a Legal Practice Perspective," *European Journal of Law and Economics* 11, no. 3 (2001): 258.

26. See http://www.lawcash.net/about/about.html (accessed June 2, 2005). Conditional loans are also called nonrecourse loans. See also http://www.expertlaw.com/library/pubarticles/lawsuit_funding.html for more on nonrecourse loans (accessed June 2, 2005).

27. George Priest and Benjamin Klein, "Selection of Disputes for Litigation," *Journal of Legal Studies* 13 (1984): 1–2.

28. The survey is available from the Inter-University Consortium for Political and Social Research (ICPSR 6587) at http://www.icpsr.umich.edu/. It covers tort, contract, and real property cases disposed of between July 1,

1991, and June 30, 1992, in forty-five jurisdictions chosen to represent the seventy-five most populous counties in the nation. (These counties account for about half of all civil filings.) A more complete description of the dataset and our empirical technique can be found in Helland and Tabarrok, "Contingency Fees, Settlement Delay, and Low-Quality Litigation."

29. American Medical Association, *AMA Tort Reform Compendium* (Chicago: American Medical Association, 1989), 19–25.

30. Further details on tests can be found in Helland and Tabarrok, "Contingency Fees, Settlement Delay, and Low-Quality Litigation."

31. Miller, "Some Agency Problems in Settlement," 199. The basic result, however, can be reversed with minor changes in assumptions. For one example, see A. Mitchell Polinsky and Daniel L. Rubinfeld, "A Note on Settlements Under the Contingent Fee Method of Compensating Lawyers," *International Review of Law and Economics* 22 (2002): 217–25.

32. Harold Demsetz, "Information and Efficiency," J*ournal of Law and Economics* 12, no. 1 (1969): 1.

33. Kritzer, "Seven Dogged Myths," 753.

34. For an example of this fee arrangement using third-party financing, see A. Mitchell Polinsky and Daniel L. Rubinfeld, "Aligning the Interests of Lawyers and Clients," *American Law and Economics Review* 5, no. 1 (2003): 165–88.

35. Cumming, "Settlement Disputes," 258.

36. Terry Thomason, "Are Attorneys Paid What They're Worth? Contingency Fees and the Settlement Process," *Journal of Legal Studies* 20 (1991): 218.

37. Patricia M. Danzon and Lee A. Lillard, "Settlement Out of Court: The Disposition of Medical Malpractice Claims," *Journal of Legal Studies* 12 (1983): 363.

38. Cumming, "Settlement Disputes," 270.

39. Olson, "Sue City."

40. Bernstein, "Procedural Tort Reform."

41. See Helland and Tabarrok, "Contingency Fees, Settlement Delay, and Low-Quality Litigation."

42. Brickman, "Effective Hourly Rates of Contingency Fee Lawyers," 657–660.

43. Hensler, "Revisiting the Monster," 190.

44. Recent work by Helland and Klick has suggested that judges prove to be ineffective protectors of the plaintiff class, placing their own desire to clear the court's docket of the case before the interests of the nominal

plaintiffs. Eric Helland and Jonathan Klick, "The Effect of Judicial Expediency on Attorney Fees in Class Actions" (FSU College of Law, Public Law Research Paper No. 138; FSU College of Law, Law and Economics Paper No. 05-07), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=637206 (accessed June 2, 2005).

45. Kritzer, "Seven Dogged Myths," 765; Kritzer, "The Wages of Risk: The Returns of Contingent Fee Legal Practice," *DePaul Law Review* 47 (1998): 275.

46. Brickman, "Effective Hourly Rates of Contingency Fee Lawyers," 699–703; Brickman, "The Market for Contingent Fee-Financed Tort Litigation: Is It Price Competitive?" *Cardozo Law Review* 25 (2003): 65–128.

47. Ibid.

48. Olson, "Sue City."

49. Bernstein, "Procedural Tort Reform."

50. Tillinghast-Towers Perrin, "U.S. Tort Costs: 2004 Update. Trends and Findings on the Costs of the U.S. Tort System" (Tillinghast-Towers Perrin, 2005), 5.

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52. David Studdert and Troyen Brennan, "Beyond Dead Reckoning: Measures of Medical Injury Burden, Malpractice Litigation, and Alternative Compensation Models from Utah and Colorado," *Indiana Law Review* 33 (2000): 1643–86.

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About the Authors

Alexander Tabarrok is an associate professor of economics at George Mason University and director of research for The Independent Institute. Tabarrok's recent research examines issues such as the effect of police on crime, whether "three strikes" laws deter, and how bounty hunters compare with police in arresting fugitives. Other research examines patent-system reform, methods to increase the supply of human organs for transplant, and the regulation of pharmaceuticals. Tabarrok is coauthor of the web site FDAReview.org, an extensive resource on the history, policies, and potential reform of the U.S. Food and Drug Administration. He is also the editor of *Entrepreneurial Economics: Bright Ideas from the Dismal Science; The Voluntary City: Choice, Community, and Civil Society* (with David Beito and Peter Gordon); and *Changing the Guard: Private Prisons and the Control of Crime*. His papers have appeared in *The Journal of Law and Economics*, *Public Choice*, *The Journal of Health Economics*, *The Journal of Theoretical Politics*, *American Law and Economics Review*, and many other journals. Popular articles by Tabarrok have appeared in magazines and newspapers throughout the United States. He writes regularly for the blog www.MarginalRevolution.com.

Eric Helland is an associate professor of economics at Claremont McKenna College, a senior economist at the RAND Corporation's Institute for Civil Justice, and a member of the plenary faculty at the Claremont Graduate School. He currently teaches courses on economics and the principles of economics, econometrics, and law. Helland is an expert in several fields, including law, economics, and regulation. In 2002–03, Helland was a visiting fellow at the Stigler

Center for the Study of the Economy and the State at the University of Chicago Graduate School of Business. In 2003–04 he served as a senior economist on the Council of Economic Advisers. Helland's work has been published in a wide variety of scholarly journals, including *The Journal of Law and Economics*, *The Review of Economics and Statistics*, *Regulation*, and *The Journal of Environmental Economics and Management*. He is currently an associate editor at *The Journal of Regulatory Economics.*

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