

# How Would You Like to Pay for That? The Strategic Effects of Fee Arrangements on Settlement Terms

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## I. INTRODUCTION

American lawyers are generally paid through either contingent fees or hourly fees. Under an hourly fee arrangement, the lawyer is paid a fixed dollar amount for each hour spent on the case. A contingent fee arrangement, on the other hand, pays the lawyer a percentage of the final award to the client, regardless of the time spent on the case.<sup>1</sup>

This paper focuses on the strategic role that the choice of fee arrangement plays in settlement bargaining. Our purpose is merely to raise the question of strategic behavior, on the part of parties to a dispute, in the selection of fee arrangements. It should be noted that we do not wish to claim that the strategic role of fee arrangements is either the main explanation for or the main effect of these arrangements. As the existing literature on contingent fees has demonstrated, the choice of payment scheme will unquestionably affect various aspects of the lawyer-client relationship, such as the allocation of risk, the incentives of the lawyer to exert effort and make correct recommendations to the client, and the transmission of information.<sup>2</sup> This paper is intended to complement that literature by pointing out an effect that has not yet been explored. Given that

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1. Currently, contingent fees are a common form of payment in the case of lawyers working on behalf of individuals. While contingent fees do exist in the case of lawyers working for organizations, hourly fees are more common. See Mark A. Tarasiewicz, *Corporate Clients Revisiting Use of Outside Firms*, THE LEGAL INTELLIGENCER, Oct. 31, 1994, at 51; Blane R. Prescott, *The Future of "Alternative Pricing" Methods*, N.Y.L.J., Oct. 11, 1994, at 5.

2. See, e.g., James D. Dana & Kathryn E. Spier, *Expertise and Contingent Fees: The Role of Asymmetric Information in Attorney Compensation*, 9 J.L. ECON. & ORG. 349 (1993); Patricia M. Danzon, *Contingent Fees for Personal Injury Litigation*, 14 BELL J. ECON. 213 (1983); P.J. Halpern & S.M. Turnbull, *Legal Fee Contracts and Alternative Cost Rules: An Economic Analysis*, INT'L REV. L. ECON. 3 (1983); Thomas J. Miceli & Kathleen Segerson, *Contingent Fees for Lawyers: The Impact on Litigation and Accident Prevention*, 20 J. LEGAL STUD. 381 (1991); Daniel L. Rubinfeld &

most cases are settled by negotiation, it is important to understand how the choice of fee arrangement affects these negotiations and the terms of settlement.

An important question that we do not discuss in this paper is the question of how much control the client actually has over the litigation. Where the client has great control over the lawsuit (as opposed to leaving that control with the lawyer), the strategic effects we discuss in this paper are most likely to have a significant impact. On the other hand, where the lawyer controls the case, it is less likely that the effects we describe will outweigh the principal-agent problem that exists in lawyer-client relationships. Although one might expect the lawyer to have considerable control in the stereotypical contingent fee case, we nevertheless use contingent fees as an example to illustrate the effect of strategic behavior. As our point is a conceptual one — that strategic effects could affect settlement — we make no empirical claim about the importance of the effect in any particular situation.

The basic result demonstrated in this paper is that the choice of fee arrangement will affect the negotiation process and the settlement amount in a systematic way. Each party to an action (i.e., the defendant and the plaintiff) will tailor her settlement offer to the payoffs faced by her opponent, these payoffs in turn being shaped by the fee structure under which the opponent is operating. A client whose lawyer is paid on an hourly basis must pay more when her lawyer works more hours. Because every hour spent by the lawyer at trial reduces the net payoff to the client, the client will be eager to have the case resolved in negotiation, rather than at trial. She will, therefore, be willing to accept a less favorable settlement offer than would be the case if trial were costless to her. In other words, the “reservation value” — the smallest amount the plaintiff will accept or the largest amount the defendant will offer instead of going to trial — is lower for the plaintiff and higher for the defendant. In contrast, a party who faces no additional legal fees if the case goes to trial will be able to extract a more favorable settlement. As will be shown, contingent fees offer a strategic advantage in settlement negotiations because they put the client in a position in which she does not have to pay higher legal fees if the case is litigated rather than settled.

Consider the following simple numerical example which illustrates the general point to be established. Suppose that the expected

judgment in a case is \$1,000. In order to pursue the case the plaintiff must pay a lawyer, who will work for 50 hours prior to the bargaining and settlement stage. If there is no settlement, the case will go to trial and the lawyer will have to work an additional 250 hours. The opportunity cost of the lawyer's time is assumed to be \$1 per hour. At the bargaining and settlement stage, the defendant makes a take-it-or-leave-it offer to the plaintiff. If the plaintiff accepts the offer, the case settles. If the plaintiff rejects the offer, the case goes to trial.

Consider now the settlement negotiations themselves. If the plaintiff's lawyer is on an hourly fee arrangement, the plaintiff faces a cost of trial of \$250. Given an expected settlement of \$1,000, the plaintiff can expect to gain \$750 if the case goes to trial (excluding the \$50 already paid to the lawyer prior to the negotiating stage). This is her reservation value. The defendant, of course, can calculate this value and will, therefore, offer \$750 and there will be settlement.

If, on the other hand, the plaintiff's lawyer works on a contingency basis, the lawyer receives a certain percentage of any award the plaintiff obtains, whether in settlement or in litigation. The plaintiff, therefore, faces no additional costs if the case goes to trial. She is indifferent between a settlement amount of \$1,000 and going to trial where the expected judgment is \$1,000. Her reservation value for settlement, therefore, is \$1,000, and the defendant is induced to offer \$1,000.

This example demonstrates that the plaintiff will get a higher settlement offer under a contingent fee arrangement than under an hourly fee arrangement. To assess whether the plaintiff is better off under one arrangement or another, we must take into account the lawyer's fees incurred by the plaintiff. In particular, we must verify that the plaintiff will not have to pay the lawyer more under the contingent fee arrangement than she would under an hourly fee. The contract with the lawyer will be written to compensate the lawyer for the expected time that she will spend working on the case. In the present example, the case is expected to settle after 50 hours of the lawyer's time. The terms of the contingent fee arrangement will, therefore, be set to provide the lawyer with an expected compensation of \$50, the same compensation as the lawyer will receive under an hourly arrangement. Because the settlement offer is higher under the contingent fee arrangement than under an hourly arrangement, and because the lawyer receives the same payment under either scheme, the plaintiff receives higher overall value from the contingent fee arrangement.

The analysis in the rest of this paper demonstrates the impact of the factors operating in the above simple example in a more general setting. The model to be developed has a bargaining process in which both sides, rather than only the defendant, can make offers. Furthermore, the model includes endogenous determination of the contractual arrangements between lawyers and clients. The intuition one gets from the above example is confirmed by the more general model. The choice of fee arrangement impacts on the settlement process, favoring parties with contingent fee arrangements.

The paper is organized as follows. In Section II, we present the framework of analysis used throughout the paper. In Section III, the outcome of the negotiations is analyzed for the case of hourly fee arrangements for both parties. The outcome when the plaintiff has a contingent fee arrangement and the defendant has an hourly fee arrangement is examined in Section IV. In Section V, we discuss some possible extensions of our results. We conclude in Section VI.

## II. FRAMEWORK OF ANALYSIS

We begin with a plaintiff, P, who holds a claim against a defendant, D. It is expected that if the case goes to trial, the court will award the plaintiff damages in the amount J. For simplicity, we assume that both parties are risk neutral.<sup>3</sup>

Both parties' lawyers are also assumed to be risk neutral, and the market for legal services is assumed to be competitive. These assumptions imply that lawyers earn zero expected profits. The contract between a client and her lawyer must, therefore, just cover the lawyer's expected opportunity cost. Finally, we assume, without loss of generality, that the opportunity cost to the lawyer of spending an hour on a case is 1.

Events occur in the following order. At  $t=1$ , P and D hire lawyers and specify fee contracts with them. They can choose between contingent fees and hourly fees, subject only to the constraint that the lawyer receive enough to cover her expected opportunity cost. At  $t=2$ , there is a "preparation" stage, during which the lawyers do a certain amount of preliminary work that is necessary before settlement negotiations begin. This work might include legal research, discovery, the filing of motions, and so on. At  $t=3$ , settlement bargaining takes

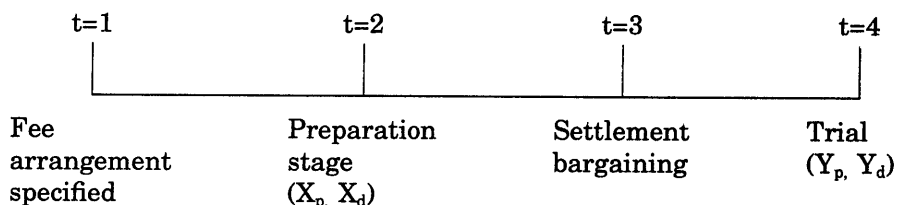
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3. Our model is easily adapted to the case of risk averse parties. Let J represent the expected settlement and let  $J^P$ ,  $J^D$  represent the expected utility for the plaintiff and defendant, respectively. It is a straightforward exercise to carry out the same analysis we have in the paper by substituting expected utilities for expected values. The paper's analysis can then be applied to any form of utility function.

place. If the parties can agree on a settlement, the case ends at this stage. Finally, if a settlement is not reached, a trial will occur at  $t=4$ . This is referred to as the "litigation" stage.

The lawyers need to spend time on the case in the preparation stage and (if it is reached) in the litigation stage. To prepare for the settlement negotiations, the plaintiff's lawyer must spend  $X_p$  hours working on the case, while the defendant's lawyer must spend  $X_d$  hours. If the parties cannot reach a settlement and the case goes to trial, the lawyers will work an additional  $Y_p$  and  $Y_d$  hours, respectively.  $X_i$  will be referred to as the "preparation cost" and  $Y_i$  will be referred to as the "litigation cost" ( $i=p,d$ ).

FIGURE I



In order to keep the model simple and to isolate the effects of the fee arrangements, it is assumed that  $J$ ,  $Y_i$ ,  $X_i$  and the parties' contractual arrangements with their lawyers are all common knowledge. This full information assumption implies that the parties will always settle rather than go to trial. In Section V.C we extend the analysis to the case in which there is some likelihood that a settlement will not be reached and a trial will occur.

The negotiation process is modelled as follows. We assume that  $D$  makes a take-it-or-leave-it offer with probability  $\alpha$ ,  $0 < \alpha < 1$  and  $P$  makes such an offer with probability  $1-\alpha$ . Under this structure, the party making the offer will calculate the amount most favorable to herself that the other party will accept. We assume, without loss of generality, that a party receiving a settlement offer will accept it if she is indifferent between the offered settlement and going to trial.

We will assume initially that  $D$  adopts an hourly fee arrangement, agreeing to pay her lawyer 1 for every hour spent on the case. We will then focus on how the outcome of the negotiations will depend on  $P$ 's choice of fee arrangement. In Section V.B we will give  $D$  a choice of fee arrangements and demonstrate that the results obtained for the plaintiff's choice also apply to the defendant's choice.

Note that we assume throughout that the expected judgment,  $J$ , is the same regardless of the fee arrangement. Of course, the fee

arrangement may also affect the expected judgment by affecting the lawyer's incentives to exert effort. We wish to abstract from this issue in order to focus on the effect on bargaining.

Finally, we assume that there are reputational constraints that prevent lawyers from "bribing" their clients to accept a settlement offer rather than go to trial. Even if the lawyer is working under a contingent fee arrangement and will therefore not receive additional payment for trial, she will never try to avoid the additional work of going to trial by offering the client a payment from her own pocket. If renegotiation were possible, and, for example, the plaintiff's lawyer was being paid under a contingent fee, the defendant could offer a low settlement and the lawyer would be prepared to pay her client up to  $Y_p$  to avoid trial. The adversary would, therefore, offer  $J - Y_p$  and there would be settlement. In a repeated game framework, however, a lawyer able to establish a reputation for refusing to renegotiate is of greater value to the client than a lawyer who is known to renegotiate. We assume that the lawyers involved have such reputations and, in order to preserve them, refuse to renegotiate.

### III. HOURLY FEE ARRANGEMENT

We begin with the case in which P hires a lawyer on an hourly fee basis, paying 1 for each hour worked by the lawyer.

D, who also has an hourly arrangement, must pay  $X_d$  before negotiations begin and, in the event of a trial, must pay her lawyer an additional  $Y_d$  in litigation costs. She faces an expected judgement of  $J$  against her. The expected cost of trial to D, therefore, is  $E_d = J + Y_d$ . Because the preparation costs are already sunk, we do not include them in calculating the costs of trial. If P makes a take-it-or-leave-it offer, which occurs with probability  $1 - \alpha$ , P will offer a settlement of exactly  $J + Y_d$ . D will accept this offer because she is indifferent between settling for  $J + Y_d$  and going to trial at an expected cost of  $J + Y_d$ . D would reject any larger settlement, since she would do better (in expectation) by going to trial.<sup>4</sup>

If there is a trial, P will get an expected award of  $J$  but will also incur an expense of  $Y_p$  in litigation costs. She therefore faces an expected gain from trial equal to  $J - Y_p$ . If D makes the settlement offer,

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4. For simplicity, we assume that there is no significant discounting between  $t=3$  and  $t=4$ . In other words, a dollar won at trial has the same value to the parties as a dollar won in settlement. This assumption merely simplifies the notation and does not affect the results.

as occurs with probability  $\alpha$ , D will offer precisely  $J - Y_p$ . P is indifferent between the  $J - Y_p$  offered as a settlement and an expected gain of  $J - Y_p$  at trial, so P will accept the offer. P would reject any smaller offer since the expected result at trial would be more favorable to her.

The expected settlement amount, under an hourly fee regime, is therefore:

$$\begin{aligned} S_1 &= \alpha(J - Y_p) + (1 - \alpha)(J + Y_d) \\ &= (J + Y_d) - \alpha(Y_d + Y_p) \\ &= J + (1 - \alpha)Y_d - \alpha Y_p \end{aligned} \quad (1)$$

This result can be understood as follows. The combined gains from settling rather than going to court are  $Y_p + Y_d$ . In other words, settling saves the legal fees associated with trial. Because the party making the offer is able to capture the entire gains from settlement and because D makes the offer with probability  $\alpha$ , the defendant's expected fraction of the gains is  $\alpha(Y_p + Y_d)$ . The expected settlement amount in equation (1) is equal to D's reservation price ( $J + Y_d$ ) minus D's expected fraction of the settlement gain.

In order to calculate the expected value of P's claim, we subtract from the settlement amount the fee that P must pay her lawyer. In the hourly fee case, this expected value is:

$$V_1 = S_1 - X_p = J + (1 - \alpha)Y_d - \alpha Y_p - X_p \quad (2)$$

#### IV. CONTINGENT FEE ARRANGEMENT

Under a contingent fee arrangement, P agrees to pay the lawyer a fraction  $\theta$  of whatever payoff P receives from the case.

D is still assumed to have an hourly fee arrangement, so if there is a trial, she faces an expected cost of  $E_d = J + Y_d$  as before. If P makes the settlement offer (as occurs with probability  $1 - \alpha$ ), P will offer  $J + Y_d$ . This is identical to P's offer when she was operating under an hourly fee arrangement.

Under a contingent fee arrangement, P faces no additional litigation costs and, therefore, prefers trial rather than settlement for any offer less than the expected award at trial,  $J$ . So if D makes the settlement offer, she must offer  $J$  in order to induce settlement — and will do so in order to avoid the litigation cost,  $Y_d$ . The expected settlement,  $S_2$ , under a contingent fee arrangement, is therefore:

$$\begin{aligned} S_2 &= \alpha J + (1 - \alpha)(J + Y_d) \\ &= J + Y_d(1 - \alpha) \\ &= S_1 + \alpha Y_p \end{aligned} \quad (3)$$

Under the contingent fee arrangement, P is only concerned with the absolute size of the payment from D and, therefore, is indifferent between trial and settlement. The joint gains from settlement are, therefore, only  $Y_d$ , the litigation costs faced by the defendant. Note that in both the contingent fee and the hourly fee cases, the expected settlement is based on the same values: the defendant's reservation value ( $J+Y_d$ ) minus the defendant's expected fraction of the settlement gain ( $\alpha Y_d$  in the contingent fee case,  $\alpha(Y_d+Y_p)$  in the hourly fee case). The two cases differ in the expected settlement amount because the total gains from settlement are smaller in the contingent fee case.

This result can also be understood in terms of "bargaining position." Because P does not bear any additional costs if the case goes to trial, P's bargaining position is enhanced. Under the existing bargaining structure, when D makes the take-it-or-leave-it offer, D can capture all of the litigation costs P saves by settling rather than going to trial. In expectation, therefore, D can capture a fraction  $\alpha$  of those litigation costs. In the hourly fee case, D can capture  $\alpha Y_p$  while in the contingent fee case D captures nothing because P faces no litigation costs. From P's point of view, this is a favorable result as she gets a more favorable settlement when she pays the lawyer on a contingent fee basis.

We now calculate the expected value of P's claim under a contingent fee. From (3), we know that P expects the settlement amount  $J+Y_d-\alpha Y_d$ . Because there will always be settlement we also know that P's lawyer will spend  $X_p$  hours on the case.<sup>5</sup> The fraction,  $\theta$ , that is necessary in order to pay the lawyer the amount she would get under an hourly arrangement is given by:

$$\theta(J+Y_d-\alpha Y_d) = X_p \quad (4)$$

After paying the fraction,  $\theta$ , to the lawyer, P receives a fraction  $1-\theta$  of the settlement amount. The expected value of P's position is therefore:

$$\begin{aligned} V_2 &= (1-\theta) S_2 \\ &= (J+Y_d) - \alpha Y_d - \theta(J+Y_d-\alpha Y_d) \\ &= (J+Y_d) - \alpha Y_d - X_p \\ &= J + (1-\alpha)Y_d - X_p \end{aligned} \quad (5)$$

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5. The possibility that there will not be settlement is discussed in Section V.C.



From (5) and (2), we can see that the expected value of P's claim is higher under the contingent fee arrangement,  $V_2$ , than under the hourly fee arrangement,  $V_1$ , by exactly  $\alpha Y_p$ .

## V. EXTENSIONS AND DISCUSSION

### A. *A Note on the Structure of Contingent Fees*

In modelling contingent fees, we have assumed that the fraction given to the lawyer,  $\theta$ , is constant. The lawyer receives the same percentage of the award, regardless of the stage at which the case ends. This is so despite the fact that the work involved in trial is usually much greater than the work involved in a case that settles. This assumption is critical to our conclusions. The client is indifferent between receiving (or paying) a given amount,  $J$ , as a settlement or as a judgment only because the amount paid to the lawyer does not depend on whether or not there is a trial. If the fraction given to the lawyer were higher in cases where litigation occurred, the party's bargaining position would be weakened and the contingent fee would be less attractive as compared to the hourly fee.

Although there is little reliable evidence, it appears that the percentage given to the lawyer does not vary a great deal when there is settlement as compared to when there is a trial. One study found that the percentages range from 25 - 33 percent for settlement before trial, and from 33 - 40 percent if trial is necessary.<sup>6</sup> The results of this paper offer one possible reason why contingent fees would not be structured in a manner that is highly sensitive to whether or not the case goes to trial.

### B. *Contingent Fees for the Defendant*

Until now, we have assumed that the defendant's lawyer is operating under an hourly fee arrangement, and we have examined the effect of varying the plaintiff's payment scheme. If we vary D's arrangement, we obtain results analogous to those obtained for P. (For

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6. See DEBORAH HENSLEN ET AL., COMPENSATION FOR ACCIDENTAL INJURIES IN THE UNITED STATES 135-36 (1991); CHARLES W. WOLFROM, MODERN LEGAL ETHICS 532 n.44 (1986). It is likely that these figures overstate the differences between trial and settlement because cases that are routine and likely to settle will require a lower percentage payment than will a case that is viewed as precedent setting. In other words, a case that is expected to settle with greater probability will require a lower percentage payment to the lawyer in order to give the lawyer proper compensation in expectation. Variations in the percentage paid to the lawyer based on the probability of trial ex ante are consistent with our analysis which assumes only that for a given case, the contingent fee is independent of whether or not there is a trial.

the defendant, we define a contingent fee as a fraction,  $\theta$ , of the amount the lawyer saves for the client relative to some threshold,  $W$ .)

It can easily be shown that  $D$  is better off under a contingent fee arrangement regardless of the fee arrangement chosen by  $P$ . As discussed,  $P$ 's arrangement affects the offer made when  $D$  makes the take-it-or-leave-it offer.  $D$ 's arrangement will similarly affect the offer when  $P$  issues the take-it-or-leave-it offer. Under an hourly fee arrangement (as we have assumed up to now),  $P$  will offer  $J+Y_d$ . Under a contingent fee arrangement,  $P$  offers  $J$  because  $D$  is indifferent between trial (with expected cost  $J$ ) and settlement for  $J$ .  $D$  prefers trial to any settlement greater than  $J$ . This arrangement prevents  $P$  from capturing a fraction  $(1-\alpha)$  of the litigation costs ( $Y_d$ ) that  $D$  faces under an hourly fee arrangement in the event of a trial. Compared to the hourly fee arrangement, therefore, the expected settlement is  $(1-\alpha)Y_d$  lower if the defendant has a contingent fee arrangement.

If both sides have a contingent fee arrangement, the settlement amount will be  $J$  since neither side faces litigation costs. Neither side will be satisfied by an amount less favorable to them than the expected trial outcome.

### C. Possible Lack of Settlement

Up to this point, our model ensures that settlement is always reached and that trial never takes place. Although the bargaining effects discussed hinge on the fee structure in the event of trial, and even though the lawyer is committed to do trial work under the contingent fee arrangement, the parties never actually go to court due to the full information assumption. The strategic role of contingent fees, however, will still exist when there is some probability that settlement will not occur and a trial will take place.

To allow for the possibility of a trial, assume that at  $t=2$  there is a probability,  $\rho$ , that settlement bargaining will fail because, say, one of the parties acts irrationally and refuses to settle. In this case, settlement occurs with probability  $1-\rho$ .<sup>7</sup>

To see that contingent fee arrangements will continue to have an advantage over hourly fees, consider first the expected payment to the plaintiff under the alternative contractual arrangements. With

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7. The use of an exogenous probability of failure to settle is an extremely simple assumption. The settlement literature has various models in which the likelihood of failure to settle is endogenously determined. See, e.g., Lucian A. Bebchuk, *Litigation and Settlement Under Imperfect Information*, 15 RAND J. ECON. 404 (1984).

probability  $\rho$ , there will be a trial and the plaintiff will get  $J$ . With probability  $1-\rho$ , there will be settlement, and the expected settlement amount will be the same as in the analysis presented earlier.  $P$  will, therefore, still do better with a contingent fee arrangement in those cases that settle. The expected payment from the defendant will be higher under a contingent fee arrangement than under hourly fees.

Finally, we must consider the amount paid to the lawyer. Because there is a probability  $\rho$  that the case will not settle, the lawyer expects to work  $X_p$  hours in preparation for settlement bargaining, plus, with probability  $\rho$ , an additional  $Y_p$  for trial. The expected fees paid under an hourly arrangement are therefore equal to  $X_p + \rho Y_p$ . Under the contingent fee arrangement, this is the amount that must be paid to the lawyer, by allocating the appropriate percentage of the expected judgment. In other words, under either of the fee arrangements, the expected fees to the lawyer will be the same. Because the expected recovery will be higher under contingent fees, the expected value to the plaintiff will also be higher under these arrangements.<sup>8</sup>

## VI. CONCLUSION

The economic literature on lawyer-client fee arrangements has largely focused on the effects that these arrangements have on the various dimensions of the lawyer-client relationship. This paper has demonstrated that these fee arrangements also have a strategic effect on settlement negotiations. They affect the bargaining position of the party employing them and, therefore, the terms of settlement.

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8. The analogous results for  $D$  also hold.  $D$  is better off with a contingent fee arrangement, even if there is a chance that the case will not settle.

