

AN ECONOMIC EXPLANATION OF THE DUAL CONTINGENT FEE

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I. INTRODUCTION

The emergence of the dual contingent fee, whereby a client pays her attorney at one contingent fee rate if the case is litigated and at a lower rate if the dispute is settled, deserves explanation. In the United States, dual contingent fees are emerging in highly competitive markets for legal services. This article explains this fee structure as the market response to a client (principal) attorney (agent) contracting problem. Clients benefit from this relatively new pricing structure not solely, or even primarily, because it lowers the proportion of a settlement paid an attorney. The benefits for clients are more complex. This article reviews some recent work, by economists, on client attorney contracting and then turns to an analysis of contingent fees.

One of the central analytic tasks in economics is to explain the determination of market prices and the incentive structures associated with different modes of payment. Therefore, it is not surprising that economists have become interested in the pricing of legal services. In the United States, plaintiffs bringing civil suits pay their attorneys by the hour or a contingent fee. Among many

members of the bar and the general public, attorneys who collect contingent fees do not enjoy the same professional status as those who collect hourly fees.¹ Criticisms of contingent fees include that they foster excessive litigation and generate exorbitant remuneration for attorneys.

This article explains why contingent fees are prevalent in the market for legal services and why dual contingent fees solve a fundamental principal/agent problem that arises between attorneys and their clients when evaluating settlement offers. Contrary to the popular view, economic analysis suggests that a contingent fee has three desirable properties; (i) it solves the liquidity problem of clients who cannot afford substantial upfront legal expenses; (ii) it improves risk sharing between client and attorney under the likely condition that the attorney faces less risk in the case than does the client; and (iii) it provides an incentive for the attorney to supply an optimal amount of legal services when the client cannot accurately monitor those services. By giving the attorney a stake in the case, a contingent fee mitigates this potential moral hazard. While focusing on points (ii) and (iii), this article argues that all three explain the use of contingent fees and shows why contingent fees are compatible with client welfare and good market performance.

As suggested above, I begin with a brief review of recent work by economists on attorney/client contracting. Driving the analysis is the nature of the information relevant to a legal dispute. As the reader will quickly appreciate, the identity of who can most effectively assess the quality of a case and the magnitude of potential damages shapes the contracting process. The problems that arise are referred to in the literature as principal/agent problems stemming from asymmetrical information. Rubinfeld and Scotchmer develop a model of unrestricted contracting² between risk

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1. The Code of Professional Responsibility restricts the use of contingent fees to those cases where clients cannot pay a reasonable fixed fee. MODEL CODE OF PROF'L RESPONSIBILITY EC 2-20 (1980). Rule 1.5(d) of the American Bar Association Rules of Professional Conduct prohibits the use of contingent fees in criminal and domestic relations cases. MODEL RULE OF PROF'L CONDUCT R. 1.5(d) (1990).

2. Daniel L. Rubinfeld & Suzanne A. Scotchmer, *Contingent Fees for Attorneys: An Economic Analysis*, 24 RAND. J. ECONOMICS 343 (1993). In a model of contracting with no restrictions, Rubinfeld and Scotchmer demonstrate that the optimal contract, when plaintiffs are more risk averse than attorneys, is for the attorney to "purchase the case" from the client for a fixed fee and then settle or try the case and retain the proceeds. They admit that this could give rise to a moral hazard problem, wherein the plaintiff, having sold the case, turns around and sells information to the defendant. *Id.*

neutral plaintiffs and attorneys.³ They argue that in the case of asymmetric information, wherein the client knows the quality of the case, but the attorney does not, the attorney will use fee structure, combinations of fixed fees and contingent fees, to screen cases and to signal the quality of the legal services offered.

Building on the Rubinfeld and Scotchmer model and assuming risk neutrality on the part of all parties, Kupczak argues that fee structure is used to signal case quality to a defendant.⁴ The source of asymmetric information is different in this analysis. Kupczak assumes that the plaintiff knows more about case quality than does the defendant, but has no credible way of signaling quality. Defendants, while ignorant of the quality of the instant case, know the reputation of the plaintiff's attorney. Attorneys with high quality cases charge hourly rates while those with low quality cases charge a contingent fee. One implication of the analysis is that attorneys specialize in charging either hourly fees or contingent fees. It is not clear that this is consistent with the evidence. Fee structure may be driven by the legal category of a case, e.g., property, contract, tort, rather than by the quality of the case. Thus the attorney that specializes by case type, a typical practice, will appear to specialize in the charging of only one type of fee.

More recently, Hay⁵ attempts to derive the optimal contingent fee that minimizes the agency costs associated with underinvestment of attorney effort. Hay assumes that the attorney

3. A risk neutral person cares only about the expected value of a decision and not the dispersion of possible outcomes about the expected or mean value. For example, a risk neutral person would treat the following two lotteries as equivalent. Lottery One has two payoffs (\$60 or \$40) that are equally likely. Therefore its expected value is: $EV_1 = \frac{1}{2}[\$60] + \frac{1}{2}[\$40] = \$50$. Similarly for Lottery Two: $EV_2 = \frac{1}{2}[\$0] + \frac{1}{2}[\$100] = \$50$. Lottery Two is said to be riskier than Lottery One because its range in payoffs is greater [\$0 to \$100] as compared to Lottery One's [\$40 to \$60]. In other words, Lottery One is less risky because it offers a payoff between \$40 and \$60 while Lottery Two could leave a person with nothing [\$0] or a relatively large payoff [\$100]. The dispersion of returns for Lottery Two is higher than for Lottery One. Nevertheless, a risk neutral person is indifferent between the two lotteries because they offer the same expected value of \$50. See any standard intermediate microeconomic text, e.g., ROBERT S. PINDYCK & DANIEL L. RUBINFELD, *MICROECONOMICS*, ch. 5 (5th ed 2001).

4. S. Kupczak, *Contingent Fees or Hourly Rates? Reputational Considerations in Fee Selection*, xerox, (1995); Kevin M. Clermont & John D. Currihan, *Improving on the Contingent Fee*, 63 CORNELL L. R. 529 (1978); James D. Dana, Jr. & 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*, 13 BELL J. ECON. 213 (1983); Andrew F. Daughety & Jennifer F. Reinganum, *Endogenous Sequencing in Models of Settlement and Litigation*, 9 J. L. ECON. & ORG. 314 (1993); Avery W. Katz, *The Effects of Frivolous Lawsuits on the Settlement of Litigation*, 10 INTL. R. L. & ECON. 3 (1990); Janet K. Smith & Steven R. Cox, *The Pricing of Legal Services: A Contractual Solution to a Problem of Bilateral Opportunism*, 14 J. LEGAL STUDIES 167 (1985); Kathryn E. Spier, *The Dynamics of Pretrial Negotiations* 59 REV. ECON. STUDIES 93 (1992).

5. Bruce L. Hay, *Contingent Fees and Agency Costs*, 25 J. LEGAL STUDIES 503 (1996).

has superior knowledge of the value of the case compared to the client; that both the client and attorney are risk neutral; and that the possibility of settlement has no effect on the optimal contingent fee rate. Like Kupczak's analysis, but unlike that of Rubinfeld and Scotchmer and of Hay, this paper seeks to explain the market rationale of contingent fees and to derive optimal fee rates. Moreover, unlike the above studies, this paper explores the settlement process.

Information problems invariably are the point of departure in explaining contingent fees. In the present analysis, unlike that of Rubinfeld and Scotchmer and of Kupczak, the attorney, not the plaintiff, is assumed to be in a better position to assess the merits of a case. Although the plaintiff possesses relevant information, she cannot accurately estimate either damages or the likelihood of prevailing at trial. She is uncertain about the stakes and her prospects. Moreover, she cannot gauge the quantity of legal services being provided by her attorney. The latter monitoring problem permits an attorney to under invest in the effort devoted to a case when the client pays an hourly rate. The market solution to this potential principal/agent problem is having the parties contract for a contingent fee. By contrast, where there is no monitoring problem, for example where in-house attorneys of a corporation can assess the legal services of outside counsel, the client is billed by the hour.⁶

One difference between charging clients by the hour and charging a contingent fee is the risk borne by the attorney. Aside from the solvency of the client, an attorney faces no risk when billing by the hour. Win or lose, the attorney collects her fee. By contrast, an attorney charging a contingent fee collects only if she wins at trial or successfully settles the case. And yet there is reason to believe that the significance of this difference is easily exaggerated. An attorney has a portfolio of cases. Some cases may go unusually well; the results of others may be disappointing and many, perhaps most, unfold as the attorney had anticipated. Diversification across a set of cases drastically reduces the risk an attorney faces in her practice. In other words, disappointing fees from some cases are offset by big wins in other cases. An attorney's average compensation from contingent fees may be very stable.

6. A further contention here is that, if the in-house legal staffs of corporations monitor the legal services provided by outside counsel and corporations typically are involved in contract cases, then it is expected that attorneys specializing in corporate contract work will charge hourly fees. What is behind this is the client monitoring problem and not, as Kupczak has it, the inability of a know-ledgeable client to credibly signal case quality to an uninformed defendant.

Therefore, little risk can be directly attributable to the mode of payment.

While most analyses of contingent fees assume risk neutrality of agents, here it is assumed that the client is risk averse⁷ and the attorney risk neutral. These seem to be reasonable assumptions. Clients can have a lot at stake in a legal dispute. The downside risk of losing at trial may weigh heavily on client welfare. Clients can rarely diversify across a portfolio of cases. By contrast, precisely because she has a portfolio of cases, the attorney faces little risk. Therefore, for analytic if not descriptive reasons, the attorney can be treated as being risk neutral.

Finally, the possibility of settlement is integral to the analysis. As demonstrated below, while solving the problem of monitoring attorney effort, a contingent fee drives a wedge between the interests of the client and the attorney when it comes to making a settlement offer.

Thus, a second principal/agent problem may exist. In particular, under the assumptions made, attorneys are more likely to favor settlement and to advocate smaller settlements than are in the best interests of their plaintiff clients. In the face of asymmetric information, wherein the attorney can evaluate the case more accurately than the client, the attorney clearly has an advantage in counseling her client concerning settlement. The analysis explains why divergent attorney/client interests concerning settlement arise and how those interests can be made compatible.

II. THE MODEL

To assert a legal claim by filing a suit is to begin a process of decision-making under conditions of uncertainty and to contract with an agent-attorney who possesses both superior information and expertise to interpret that information than does the principal-client. Economics offers a theory of decision-making under conditions of uncertainty and a theory of principal/agent problems arising from asymmetric information. To explore the contractual relationship between an attorney and her client, a simple economic model is developed. The primary advantage of using a formal model is that it permits tying together, within a coherent framework, all the issues of interest including attitudes toward risk, modes of payment for legal services, the origin of principal/agent problems, incentive compatible contracting, and settlement. Although a formal model is presented, the analysis makes no mathematical demands on the reader beyond a bit of algebra. Moreover, the main

7. See discussion of the precise meaning of risk aversion, *infra*.

argument can be comprehended without reliance on the formal model.

The model has three components. One, behavioral assumptions are made about the goal the client wishes to achieve by filing a lawsuit and what the attorney seeks to achieve by taking the case. These motivations are represented by twin structural equations below. Two, there are factors including several production and utility function parameters determined by technology, on the one hand, and the psychological makeup of the client, on the other, that are treated as givens (exogenous variables) within the model. And, three, there is a set of endogenous variables that the model is designed to explain. The model presented here determines the hours of legal services contracted for by the client and supplied by the attorney, the hourly attorney fee; an alternative contingent fee, the minimum settlement offer acceptable to the client, the attorney's expected net earnings from the case, and the expected welfare (a utility index number) of the client. The model's endogenous and exogenous variables are defined below. We begin with a discussion of several basic assumptions.

A. Assumptions

- i) The client-plaintiff is risk averse and maximizes expected utility.

- ii) The attorney is risk neutral and maximizes the expected net revenue of a case.

- iii) Legal services, of constant quality, are measured in hours.

- iv) The probability of winning a case increases with the employment of more legal services, but it increases at a diminishing rate. This is an example of the pervasive phenomenon of diminishing returns to inputs.

- v) Attorneys are fully employed in a competitive market for legal services.

B. Discussion of Assumptions

Assumptions (i) and (ii) are not necessary, but are made for convenience. For the optimal risk spreading between client and attorney implied by this analysis all that is required is that the client be *more* risk averse than her attorney, not that the attorney be risk neutral. Assumption (iii) collapses the quantity and quality of legal services. Again this simplifies the analysis without influencing the implications of the model. Assumption iv) is a standard, empirically grounded assumption about any production process. Assumption v) defines the opportunity cost of providing legal services. Finally, the magnitudes of the model parameters and the equilibrium values of the endogenous variables are illustrative only.⁸ A numerical example is employed in order to render the analytic argument more transparent.

C. Definitions of Variables

1. Endogenous Variables (to be determined by the model)

L – hours of legal services

w – hourly fee

c – percent contingent fee

2. Exogenous Variables (givens)

J – potential trial judgment = \$200,000

Y – wealth after incident but before trial or settlement = \$100,000

$\pi(L)$ – the probability of the client winning at trial, an increasing function of the hours of legal services employed = aL^α

a – parameter in the probability of winning function = .04

α – probability of winning function parameter = .60

β – parameter in the client's utility function = $\frac{1}{2}$ (implies risk averse behavior)

γ – parameter in legal services cost function = 1.5

δ – parameter in the legal services cost function = 2

k – the costs of reaching settlement as a proportion of the costs of litigating = $\frac{1}{2}$

8. In the text, the calculated values of the endogenous variables have been rounded-off. The actual values to four decimal places are reported in brackets and used in subsequent calculations.

D. Structural Equations

The client seeks to maximize her expected utility by filing a lawsuit. If she pays her attorney an hourly fee, her expected utility is given by equation (1):

$$EUP = \pi(L)[Y + J - wL]\beta + (1-\pi(L))[Y - wL]\beta$$

Where Y is the client's present wealth; J is the potential trial judgment; w is the hourly rate for legal services, and L is hours of legal services employed. $\pi(L)$, the probability of winning at trial, equals aL^α . $a > 0$ and $0 < \alpha < 1$ imply that the probability of winning at trial increases with L but increases at a diminishing rate. The expected utility of going to trial [EUP] is the weighted sum of the utility associated with winning plus the utility associated with losing, where the weights are the probabilities of winning [$\pi(L)$] and losing [$1-\pi(L)$]. Thus, the utility of winning, the first term on the right hand side (RHS) of equation (1), is given by the probability of winning at trial times the utility of the wealth position associated with winning. Similarly, the second term on the RHS specifies the weighted utility associated with losing at trial.

The client is assumed to be risk averse. That is, she cares not only about the expected value of a decision but also the dispersion of possible outcomes. To capture this attitude toward risk, economists look not to the mathematical *expected value* but the *expected utility* of a decision. Here we assume that the client experiences diminishing marginal utility of wealth. Diminishing marginal utility of wealth suggests, for example, that a person's tenth million dollars of wealth, while increasing utility, increases it less than did the first million dollars of wealth, just as the first glass of water quenches one's thirst more than does a second glass or certainly a fourth glass.⁹ Operationally, this is implied in equation (1) by setting $\beta = 1/2$, *i.e.* equating the client's utility with the square root of her wealth. To understand this, return to the example of two lotteries given in footnote 3. Consider the expected utility of Lottery One. $EU_1 = 1/2\sqrt{60} + 1/2\sqrt{40} = 14.07$ (utility index number by which comparisons can be made). For Lottery Two the expected utility is: $EU_2 = 1/2\sqrt{0} + 1/2\sqrt{100} = 5.00$. Thus a person subject to diminishing marginal utility of wealth (Empirically that includes most of us.) would prefer the less risky Lottery One to the more risky Lottery Two ($EU_1 > EU_2$). Such a person is said to be risk averse.

9. Pindyck & Rubinfeld, *supra* note 3; Robert Whaples, et al., *What Should Lawyers Know About Economics?*, 48 J. LEGAL EDUCATION 120 (1998).

Now we turn to the motivation of the attorney. As suggested above, the attorney is assumed to maximize her expected net revenue from the case. The expected net revenue to an attorney, who bills by the hour, is given by equation (2):

$$ERA = wL - \gamma L \delta$$

Where net revenue ERA is defined as gross revenue [wL] minus costs [$\gamma L \delta$]. $\gamma > 0$ and $\delta > 1$ imply that the incremental cost of supplying legal services is an increasing function of L.

Increasing incremental (marginal) costs are pervasive in the production of goods and services and follow directly from the phenomenon of diminishing returns.

III. ANALYSIS

This section analyzes several contracting problems that can arise between a client and her attorney. The first provides a benchmark for the subsequent analysis.

A. Knowledgeable Client: The Client Can Effectively Monitor the Attorney's Work Product

In negotiating a contract, the client seeks to maximize EUP by agreeing on satisfactory values for L and w. Simultaneously, the attorney strives to maximize ERA by negotiating satisfactory values for L and w. Analytically, we have two equations with two unknowns L and w. After substituting the numerical values of the parameters into eqs. (1) and (2), they become:

$$EUP = .04L.6[\$300,000 - wL]^{1/2} + (1-.04L.6)[\$100,000 - wL]^{1/2} \quad (1')$$

$$ERA = wL - 1.5L^2 \quad (2')$$

We seek to solve this set of equations for the optimal values of L^* and w^* that simultaneously maximize the client's EU and the attorney's ER. Unfortunately, no analytic solution exists for eqs. (1') and (2'), *i.e.* no direct mathematical methods exist for solving these twin, non-linear equations for optimal values of L^* and w^* . In spite of the fact that these equations cannot be solved with traditional mathematical methods, equations (1') and (2') are meaningful expressions.

They capture some essential characteristics of the economic behavior exhibited in the contracting process between a client and an attorney.

To make any headway, we must employ numerical methods. Such methods involve using a high speed computer to iteratively substitute numerical values for L and w in eqs. (1') and (2') until a combination of values for L and w is found that equates the demand for legal services on the part of the client with the quantity supplied by the attorney [L] at an equilibrium price [w]. Using mathematical

software *Maple 6* and given the model's parameter values specified above, we find that $L^* = 120$ hours and $w^* = \$360$ an hour.¹⁰ These optimal values simultaneously maximize both the client's EUP and the attorney's ERA. In addition, $\pi(L)$, the probability of winning at trial, is found to equal .70 [.7072]; $EU^* = 428.2$ utils (This is a index number useful for making a later comparison.); the total attorney fee is $w^*L^* = \$43,200$ and, after subtracting expenses, $ERA^* = \$21,600$.

Thus, if the client can monitor the quantity of legal services provided by the attorney, and quality holds constant, an incentive compatible contract results.¹¹ Later, the assumption that a client can monitor her attorney's work product is relaxed and we investigate another fee structure that solves this potential principal/agent problem. But first we explore a way of improving the risk sharing of the case between the risk averse client and her risk neutral attorney.

B. Improved Risk Sharing

Risk sharing between a risk averse client and a risk neutral attorney is improved when a contingent fee replaces an hourly fee. To understand this, we must first find the contingent fee implied by the model. In a competitive market for legal services the *expected, or ex ante*, revenue from a given case is the same whether collected by billing hours or collecting a contingent fee. Therefore, $\pi(L)Jc = wL \rightarrow .70(\$200,000)c = \$360(120 \text{ hours}) = \$43,200$ which implies that the relevant contingent fee is $c^* = .30$ [.3054]. Moreover, if we employ this contingent fee and recalculate the expected utility of the client, we find:

$EUP = .70[\$100,000 + \$200,000(1-.30)]\frac{1}{2} + .30[\$100,000]\frac{1}{2} = 438.3$ utils. Thus, the risk averse client is better off paying a contingent fee.¹²

C. Imperfect Information: The Client Cannot Effectively Monitor the Attorney

The inability of the plaintiff to monitor the amount of legal services supplied by her attorney is the basis of a potential principal/agent problem. In short, the client has no way of ascertaining whether she is receiving the optimal amount of services

10. *Maple 6*, published by Waterloo Maple Inc. (2000), is a widely used mathematics software program.

11. A contract is said to be incentive compatible when it aligns the interests of a principal and an agent. In this case the attorney/agent prefers to supply the amount of legal services that are in the best interest of the client/principal.

12. As the result of paying a contingent fee rather than a hourly rate, the client's utility index has increased: $EU_{\text{Hour Fee}} = 428.2$ utils < $EU_{\text{Contingent Fee}} = 438.3$ utils.

given the particulars of her case. One solution is to negotiate a contract whereby the client pays [cJ] if the trial is won and pays nothing if trial is lost. As demonstrated above, a contingent fee improves the welfare of the client without reducing that of the attorney. To see that latter result, substitute the contingent fee into eq. (2') and solve for ERA.

$$ERA = .70[.30(\$200,000) - 1.5(120)2] + .30[-1.5(120)2] = \$21,600$$
 With a 70 percent probability the attorney earns a fee of \$60,000 and with a probability of 30 percent she collects no fee. After deducting expenses, the attorney's expected net revenue remains at \$21,600, the same as when she billed by the hour. But by giving the attorney a direct stake in the outcome of trial, a contingent fee provides the correct incentive for the attorney to provide the optimal amount of legal services even if the client cannot monitor those services. Nevertheless, a contingent fee can generate another principal/agent problem when it comes time for the attorney to recommend a possible settlement.

D. Settlement with a Contingent Fee: A Second Principal/Agent Problem

The minimum acceptable settlement to the client-plaintiff is conditioned on the expected outcome of trial. That is, the minimum acceptable offer to the client must yield at least as much utility as the expected utility of litigating the dispute. Thus to find the minimum offer [JP] acceptable to the client, set: $EUP_{\text{Trial}} = EUP_{\text{Settle}}$
 $= 438.3 = [\$100,000 + JP(1-.30)]\frac{1}{2} \rightarrow JP = \$132,604$. Therefore, in this case, a certain settlement of \$132,604 leaves the client as well off as if she faced the risk of a trial with a 70 percent chance of winning \$200,000.

Under a contingent fee contract, the attorney's law firm bears the cost of mounting the case. These expenses are invariably lower if the case is settled rather than litigated. For the purpose here, assume that the costs of settlement, borne by the law firm, are equal to one half the costs of trial litigation, [$k = \frac{1}{2}$]. Table 1 presents the respective payoffs to the client and the attorney of going to trial or reaching settlement.

Table 1
Expected Payoffs to Client and Attorney ($c^* = .30$)

| | <u>Total</u> | <u>Client</u> | <u>Attorney</u> | | <u>Legal Expenses</u> |
|--------|--------------|---------------|-----------------|------------|-----------------------|
| | | | <u>Gross</u> | <u>Net</u> | (Borne by Attorney) |
| Trial | \$141,440 | \$98,240 | \$43,200 | \$21,600 | \$21,600 |
| Settle | 132,604 | 92,110 | 40,494 | 29,694 | 10,800 |

At the minimum settlement offer acceptable to the client-plaintiff, the attorney favors settlement over going to trial, because she collects higher net revenue. See Table 1. Indeed, in the face of imperfect information, the attorney is willing to urge settlement for an amount as low as:

$$ERA_{\text{Trial}} = ERA_{\text{Settle}} = \$21,600 = .30JA - \frac{1}{2}(1.5)(120)^2 \rightarrow JA = \$106,090.$$

This represents the minimum settlement the attorney is willing to recommend. Because it is substantially lower than the settlement offer that is in the client's best interest, a second principal/agent problem exists.

E.. A Dual Contingent Fee

One solution to this principal/agent problem is to employ dual contingent fees – one contingent rate if the case goes to trial and another contingent rate if the case is settled. We already know the contingent rate if the case goes to trial: $c^* = .30$. To calculate the optimal contingent rate should the case be settled, solve the two equations below for cS and JS . It is necessary to recalculate the settlement offer [JS] because it depends on the value of cS .

$$EUP_{\text{Settle}} = [\$100,000 + JS(1-cS)]\frac{1}{2} = 438.3$$

$$ERA_{\text{Trial}} = ERA_{\text{Settle}} = \$21,600 = cSJS - \frac{1}{2}(1.5)(120)^2$$

Solving the two equations yields: $cS = .26$ [.2602]¹³ and $JS = \$124,510$. As before (see Table 1), the client's net is \$92,110 [.74(\$124,510)]. Similarly, the attorney's expected net revenue remains the same as if the case had proceeded to trial and is \$21,600 [.26(\$124,510) = \$32,400 minus \$10,800 in expenses]. Therefore, the attorney has no personal financial stake in the case being settled rather than litigated and, thus, can recommend

13. An attorney is, of course, unlikely to charge a contingent fee of exactly 26 percent. What the model suggests is that the attorney and client might negotiate a contract that calls for a 30 percent contingent if the case goes to trial and a lower percent fee should the case be settled.

settlement based on the merits of the case, the perceived wishes of the client, and the offer made by the defendant.

Dual contingent fees, one if the case goes to trial and another if the case is settled, align the interests of the client and attorney. Under a dual fee, the attorney is indifferent, on the basis of expected compensation, between litigating and settling the case. With JS the plaintiff is as well off as she would be if she demanded JP in settlement or the case went to trial. By aligning the financial interests of the plaintiff and her attorney, a dual contingent fee permits legal issues, rather than expected compensation, to weigh more heavily in the choice of going to trial or reaching settlement.¹⁴

Finally, a dual contingent fee has an ambiguous effect on the probability of reaching settlement because:

$$JP > JS > JA$$

Recall that [JP] is the settlement offer with a single contingent fee; [JS] is the settlement offer with a dual contingent fee; and [JA] is the lowest settlement offer that an attorney might recommend to a client who cannot effectively monitor the work product of the attorney. If clients determine the minimum acceptable settlement offer, the dual contingent fee will increase the likelihood of reaching settlement because [JS < JP]. On the other hand, if attorneys typically are more influential than clients in setting the minimum acceptable offer, the dual contingent fee will reduce the likelihood of reaching settlement because [JS > JA].

IV. CONCLUSION

This essay offers an explanation of the emergence of dual contingent fees in highly competitive markets for legal services. Such fees represent a market solution to complex contracting problems between attorneys and their clients. In particular, when an attorney has superior information about the merits of a case and her risk averse client cannot evaluate the legal services supplied, a dual contingent fee provides the basis of an incentive-compatible contract. Such a contract improves the distribution of risk between the attorney and her client, mitigates the moral hazard of the attorney under investing effort in the case, and aligns attorney/client interests governing settlement. A dual

14. Note that cS is an increasing function of $[k]$ and that $0 \leq k \leq 1$. Thus as settlement costs increase as a proportion of litigation costs the appropriate cS increases. The upper limit of cS is c at which point $k = 1$ and settlement costs equal litigation costs. While the latter is highly unlikely, k could approach 1 in the case of a settlement offer being made after trial is well underway.

contingent fee has an ambiguous effect on the probability of reaching settlement.