HOW WOULD YOU LIKE TO PAY FOR THAT?
THE STRATEGIC EFFECTS OF CONTINGENT
FEES AND RETAINER ARRANGEMENTS
ON SETTLEMENT TERMS

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Abstract

This paper focuses on the strategic role that fee arrangements between lawyers and clients play in settlement negotiations. The analysis demonstrates that, compared with an hourly fee arrangement, contingent fees and retainer arrangements strengthen the bargaining position of the side employing them. By employing one of the latter arrangements, a party to a dispute can improve the terms of settlement.

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I. INTRODUCTION

American lawyers are generally paid through contingent fees, retainer fees or hourly fees.[1]

Under an hourly fee arrangement, the lawyer is paid a fixed dollar amount for each hour spent

on the case. A contingent fee arrangement pays the lawyer a percentage of the final award to

the client, regardless of the time spent on the case. Retainer fee arrangements award the attorney

a fixed amount of money for all the work arising from a given case (or from the cases arising

over a certain period), regardless of the time involved.[2]

This paper focuses on the strategic role that the choice of fee arrangements plays in

settlement bargaining. Compared to hourly fees, contingent fees and retainer arrangements

improve the strategic position of the client.[3]

The basic result demonstrated in this paper is that the choice of fee arrangement will

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[1] In some foreign jurisdictions (e.g. Britain), contingent fees are not permitted.

[2] Currently, contingent fees and retainers are common forms of payment in the case of lawyers working on behalf of individuals. In the case of lawyers working for organizations, such arrangements exist but hourly fees are still more common. There is some evidence, however, that firms are considering expansion flat fees or "value billing" (retainers as we call them in the paper). *See,* Mark A. Tarasiewicz, *Corporate Clients Revisiting Use of Outside Firms,* THE LEGAL INTELLIGENCE, Oct. 31, 1994, at 51; Blane R. Prescott, *The Future of "Alternative Pricing" Methods,* THE NEW YORK LAW JOURNAL, Oct. 11, 1994, at 5.

[3] Contingent fees have been subjected to a great deal of economic analysis but little attention has been paid to the issue that is the focus of this paper. The literature has largely focused on the effects that contingent fees have on various aspects of the client-lawyer relationship. In contrast, this paper focuses on the strategic effect that contingent fees have on the relationship between the lawyer-client team and their opposition. The only previous discussion of the possible strategic role that contingent fees may play vis-a-vis the other side appears in Geoffrey P. Miller, *Some Agency Problems in Settlement,* 16 J. LEGAL STUD. 189 (1987), an article that largely focuses on the agency problem between lawyers and their clients. Also, in a recent, independent paper, Thomas J. Miceli, *Do Contingent Fees Promote Excessive Litigation?,* 23 J. LEGAL STUD. 211 (1994), Miceli considers the effect of contingent fees on the bargaining between the two sides, but does not identify the strategic advantage on which this paper focuses.

As to retainer arrangements, we are unaware of any prior economic analysis of these payment schemes. In a recent piece, David C. Croson & Robert H. Mnookin, *Scaling the Stonewall: Retaining Lawyers to Bolster Credibility,* unpublished manuscript, 1995, the authors analyze what they refer to as "retainers" but the arrangements they have in mind are actually non-refundable advances -- if the lawyer works for a sufficiently large number of hours, he will receive an additional payment from the client based on the number of hours worked beyond the amount provided for by the "retainer." Retainers as we define them are lump sum payments which represent the lawyer's total compensation, regardless of the time spent on the case.

affect the negotiation process and the settlement amount in a systematic way. Each party to an action (i.e., defendant and 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 lower settlement offer than would be the case if trial were costless to her. In other words, the "reservation value" that the client must obtain in order to be induced to settle is lower. 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 and retainer arrangements offer a strategic advantage 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 needs to pay a lawyer, who will work for 50 hours prior to the bargaining and settlement stage. If there is no settlement, the case goes 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 smallest amount she will accept instead of going to trial. The defendant, of course, can calculate this value and will, therefore, offer $750 in settlement and there will be settlement.

If, on the other hand, the plaintiff's lawyer is on a retainer basis, the lawyer is paid the same amount whether or not there is a trial. In this situation, therefore, the plaintiff will prefer a trial over any settlement offer of less than $1,000 - her reservation value. Knowing this, the defendant will offer $1,000 and the case will settle.

Finally, consider a contingent fee arrangement under which the plaintiff's lawyer is promised a certain percentage of any award the plaintiff obtains, whether in settlement or in litigation. As in the case of a retainer arrangement, the plaintiff 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 is therefore $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 or retainer 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 or retainer 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 or retainer

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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. Since the lawyer receives the same payment and the settlement offer is higher under the contingent fee and retainer arrangements than under an hourly arrangement, the plaintiff receives higher overall value from the former than from the latter.

The analysis in this paper demonstrates the existence of 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 can make offers, rather than only the defendant. 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 retainer or contingent fee arrangements.

One caveat is in order. 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.[4] This paper is intended to complement that literature,

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[4]See, e.g., 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 & Suzanne Scotchmer, *Contingent Fees for Attorneys: An Economic Analysis*, 24 RAND J. ECON. 343 (1993); 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).

pointing out an effect that has not yet been explored. Given that most cases are settled, it is important to understand how the choice of fee arrangement affects settlement negotiations and the terms of settlement.

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 negotiations is analysed 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 consider retainer fee arrangements and their similarity to contingent fees. In Section VI we present several possible extensions to the model and some discussion. We conclude in Section VII.

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 J in damages. For simplicity, we assume both parties are risk neutral.[5]

Both parties' lawyers are also 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 costs. Finally, we assume, without loss of generality, that the opportunity cost to the lawyer of spending an hour on a case is 1.

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[5]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 excercise to, carry out the same analysis we have in the paper by substituting expected utilities for expected values.

Events occur in the following order. At t=1, P and D hire lawyers and specify their fee contracts with their lawyers. They are free to choose any of the fee arrangement discussed in this paper, subject only to the constraint that the lawyer receive enough to cover her expected costs. 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 time might include legal research, discovery, the filing of motions, and so on. At t=3, settlement bargaining takes 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.
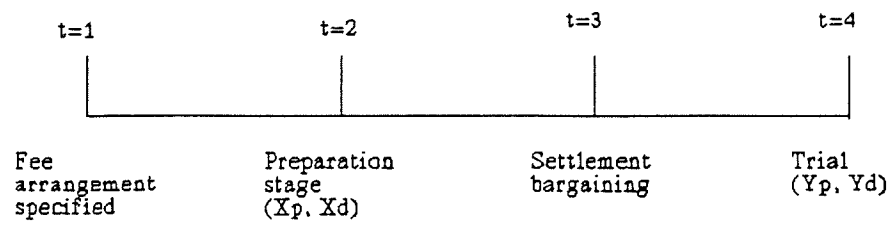
The lawyers need to spend time on the case in the preparation stage and (if it is reached) in the litigation stage. To prepare for the settlement negotiation, the plaintiff's lawyer must spend X_p hours working on the case, while the defendant's lawyer must spend X_d hours. If the parties cannot reach a settlement and the case goes to trial, the lawyers will work an additional Y_p and Y_d hours respectively.[6] X_i will be referred to as the "preparation cost" and Y_i will be referred to as the "litigation cost" (i=p,d).[7]

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[6] It is reasonable and realistic to assume $X_i < Y_i$, i=p,d. Nevertheless, nothing in the model depends on this assumption.

[7] Throughout this paper, it is assumed that the expected value of the judgment exceeds $X_p + X_d$. That is, the paper focuses on positive-expected-value suits. In a companion paper (Lucian Bebchuk, *The Effect of Contingency Fees and Retainer Arrangements on the Credibility of Threats to Sue and to Defend* (in preparation), Bebchuk analyzes the strategic role that fee arrangements may play in the context of negative expected-value suits.

FIGURE I

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        t=1                    t=2                    t=3                    t=4
         |                      |                      |                      |
         |_____|_____|_____|

Fee                    Preparation            Settlement             Trial
arrangement            stage                  bargaining             (Yp, Yd)
specified              (Xp, Xd)
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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. Section VI.B extends 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 modeled as follows. We assume that D makes a take-it-or-leave-it offer with probability α, $0<\alpha<1$, and P makes such an offer with probability $1-\alpha$. Under this structure, the party making an offer will calculate the offer most favorable to herself which 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 initially assume 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 the P's choice of fee arrangement. In Section VI.A 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 retainer 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 refuse to renegotiate in order to preserve them.

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 is therefore $E_d = J + Y_d$. 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.[8]

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 (as occurs with probability α), 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:

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

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 D makes the offer with probability α, 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:

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[8]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.

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

IV. CONTINGENT FEE ARRANGEMENT

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

D is still assumed to be on 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 the offer made when P was operating under an hourly fee arrangement.

Under a contingent fee arrangement, P faces no additional litigation costs and therefore prefers to go to trial rather than accept 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 under a contingent fee arrangement is, therefore:

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

Under the contingent fee arrangement, P is only concerned with the absolute amount of the payment from D and, therefore, is indifferent between trial and settlement. The total 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

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settlement gain (αY_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 α of those litigation costs. In the hourly fee case, D can capture αY_p while in the contingent fee case P faces no litigation costs so there is nothing for D to capture in settlement. 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 the claim to P under a contingent fee. From (3), we know that P expects the settlement amount $(J+Y_d)-\alpha Y_d$. We also know that since there will always be settlement, P's lawyer will spend X_p hours on the case.[9] The θ that is necessary in order to pay the lawyer the amount she would get under an hourly arrangement is given by:

$$\theta (J + Y_d - \alpha Y_d) = X_p \tag{4}$$

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

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

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[9]The possibility that there will not be settlement is discussed in Part VI.B.

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

V. Retainer Fee Arrangement

Under a retainer fee arrangement, P agrees to pay the lawyer some fixed amount, C, in exchange for which the lawyer agrees to perform all the work arising from the case. As before, and for similar reasons, if P makes the settlement offer and D is paying her lawyer by the hour, P will offer $J+Y_d$. If D is making the offer, P's reservation value is the same as under the contingent fee arrangement, J. Under the retainer fee arrangement, then, the expected settlement amount will be:

$$\begin{aligned}
S_3 &= \alpha J + (1-\alpha)\,(J+Y_d) \\
&= (J+Y_d) - \alpha Y_d \\
&= J + (1-\alpha)\,Y_d
\end{aligned} \tag{6}$$

The expected settlement amount in this case is the same as under the contingent fee arrangement and higher than under the hourly fee arrangement. As is true under the contingent fee arrangement, P does not bear any additional costs if the case goes to trial. P's bargaining position is, therefore, strengthened.

To calculate the expected value of the plaintiff's claim, we must subtract from the expected settlement P's payment to her lawyer, which we denote C. Because the case will always settle, P must pay $C = X_p$ in order to get the lawyer to accept the case. The value of the claim is therefore:

The expected value of the claim is as high as under the contingent fee arrangement and higher

$$V_3 = S_3 - C$$
$$= J + (1-\alpha) Y_d - X_p \qquad (7)$$

(by αY_p) than the expected value under the hourly arrangement.

VI. EXTENSIONS AND DISCUSSION

A. Contingent Fees and Retainer Fees for the Defendant

Until now, we have assumed that the defendant's lawyer is operating under an hourly fee arrangement and have examined the effect of varying the plaintiff's payment arrangement. If we vary D's arrangement, we obtain results analogous to those obtained for P. (For the defendant, we define a contingent fee as a fraction, θ, of the amount the lawyer gets for the client relative to some threshold, W.)

It can easily be shown that D is better off under a contingent fee or retainer 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 retainer or 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. Compared to the hourly fee arrangement, the expected settlement is $(1-\alpha)Y_d$ lower if the defendant has a contingent fee or retainer fee arrangement. These arrangements prevent 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.

If both sides have either a contingent fee arrangement or a retainer fee arrangement, the

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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.

B. Possible Lack of Settlement

Up to this point, our model ensures that settlement is always reached and 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 the work for trial under the contingent or retainer fee arrangements, the parties never actually go to court. The strategic role of contingent fees and retainers, 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, ρ, that settlement bargaining will fail because, say, one of the parties is "crazy" and refuses to settle. In this case, settlement occurs with probability 1-ρ.[10]

To see that contingent fees and retainer arrangements will continue to have an advantage over hourly fees, consider first the expected payment to the plaintiff under the alternative contractual arrangements. With probability ρ, there will be a trial and the plaintiff will get J. With probability 1-ρ, there will be settlement, and the expected settlement amount will be the same as in the analysis presented earlier. P will still do better with a contingent fee or retainer fee arrangement in those cases that settle. The expected payment from the defendant will therefore be higher under contingent fees or retainer fee arrangements than under hourly fees.

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[10]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 Bebchuk, *Litigation and Settlement Under Imperfect Information*, 15 RAND J. ECON. 404 (1984).

Finally, we must consider the amount paid to the lawyer. Because there is a probability p that the case will not settle, the lawyer expects to work X_p hours in preparation for settlement bargaining, plus, with probability p, an additional Y_p for trial. The expected fees paid under an hourly arrangement are therefore equal to $X_p + pY_p$. Under the contingent fee or retainer arrangement, this is the amount that must be paid to the lawyer, either by specifying that amount in the contract (retainer arrangement) or by allocating the appropriate percentage of the expected judgment (contingent fees). In other words, under any of the three fee arrangements, the expected fees to the lawyer will be the same. Because the expected recovery will be higher under retainer arrangements and contingent fees, the expected value to the plaintiff will also be higher under these arrangements.[11]

C. In-House Legal Departments

An additional form of legal payment that is commonly used is in-house legal departments.[12] Our analysis applies to these arrangements in the same way as it applies to retainer arrangements. In-house lawyers are paid on a salaried basis. They receive the same compensation regardless of the outcome of their cases. The marginal cost of any given case going to trial is, therefore, zero, just as it is in the case of a retainer arrangement. For this reason, an in-house legal department offers a firm benefits in the form of a better negotiating position, and an in-house department may be preferred for this reason.

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[11]The analogous results for D also hold. D is better off with a contingent fee or retainer fee arrangement, even if there is a chance that the case will not settle.

[12]*See* David M. Trubek, Yves Dezaley, Ruth Buchanan & John R. Davis, *Studies in the Internationalization of Legal Fields and the Creation of Transnational Arenas*, 44 CASE W. RES. L. REV. 407, 435.

Of course, if going to trial means that the company must hire additional personnel, the analysis will not apply directly. There will, in such a case, be a cost associated with going to trial that will affect the bargaining between the parties in the same way that an hourly fee arrangement affects that bargaining.

D. A Note on the Structure of Contingent Fees

In modeling contingent fees, we have assumed that the fraction given to the lawyer, θ, was 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 was 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 there is a trial or not. 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.[13] The results of this paper offer one possible reason why

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[13]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 by the defendant. 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

contingent fees would not be structure in a manner that is highly sensitive to whether or not the case goes to trial.

VII. 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 thereby the terms of settlement. A recognition of this strategic role is necessary for a full understanding of both the choice of fee arrangement and the factors shaping settlement negotiations.

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fee is independent of whether or not there is a trial.

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