THE ECONOMICS OF LAWYER REFERRALS

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ABSTRACT

This paper analyzes arrangements in which one lawyer is paid for referring a client to another lawyer. The paper employs a model of a market in which clients are imperfectly informed of different lawyers' quality; in such an environment, referral fees perform the function of potentially matching the client to the lawyer best suited to his case. The paper analyzes the problem of designing appropriate referral arrangements in the face of attorney moral hazard in both (1) the referring lawyer's decision whether to refer a case, and (2) the referee lawyer's decision of how much effort to invest in the case.

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I. INTRODUCTION

When one lawyer steers business to another, the latter will often pay a fee to the referring lawyer. In personal injury cases, for example, it is apparently not uncommon for a referring lawyer to collect one-third of the fee that the client pays the lawyer who ultimately represents her. Lawyers specializing in particular fields (particular types of torts, for example) frequently rely on the referral process for a substantial portion of their business. To the extent lawyers vary in quality and expertise, the referral process may be an important determinant in how clients fare in the legal system.

Alongside this apparently widespread use, there is widespread regulation and prohibition of paid lawyer referrals. Many jurisdictions prohibit lawyers from "splitting" their attorney's fees with lawyers outside their firm -- that is, sharing the attorney's fee with lawyers who have not actually worked on the case. Others permit fee splitting, but with strings attached; the referring lawyer must retain "responsibility"

for (even if he does not work on) the case.[1] Other jurisdictions permit

paid referrals with no strings attached, but regulated the financial terms;

in some jurisdictions, for example, referee lawyers must shoulder the

whole referral fee; they are prohibited from passing along the costs of the

referral fee to the client.[2]

Two features of this state of affairs are striking. The first is the

apparent disagreement among different jurisdictions and authorities

concerning the appropriate regulatory treatment of paid referrals. (The

disagreement is made vivid by the difference between the ABA's Model

Code and Model Rules, which differ on the issue of paying a referral fee to

a lawyer who has not worked on the case.)[3] The second is that paid

referrals apparently matter a good deal to lawyers; if so, there is reason

to expect they may matter (perhaps in different ways) to clients as well.

My objective in this paper to identify the likely welfare effects of

lawyer referrals and their regulation. In particular, I examine the

incentives facing lawyers when they are permitted to collect referral

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[1]See, for example, New York Code of Professional Responsibility DR 2-107.

[2]See, for example, California Rule of Professional Conduct 2-200(A)(2).

[3]Compare ABA Model Rule 1.5(e) (payment allowed) with ABA Model Code DR 2-107 (payment not allowed).

fees; how their incentives are affected by regulation of referrals; and how the well-being of clients is affected by banning or regulating paid referrals. So far as I am aware, these issues have never received systematic examination.[4]

The central problem motivating the analysis is the existence of imperfect information in the market for legal services. Clients are, in substantial measure, unable to assess the relative quality of different lawyers who might represent them, and are also unable to monitor their performance in a case. A process of paid referrals creates both an opportunity and a danger: the process may serve to improve clients' welfare by placing them with the highest-quality lawyers; or the process may simply be one by which lawyers line their own pockets with no benefit (or some detriment) to clients. My purpose is to see how clients are likely to fare, and what the appropriate regulatory treatment of referrals may be, in such a market environment.

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[4]The only economic model of referrals I am aware of is a study of medical referrals. See Marc pauly, The Ethics and Economics of Kickbacks and Fee Splitting, 10 Bell J. Econ. 344 (1979). That model addresses issues distinct from the ones we consider here, though it overlaps with the present article in showing that a ban on referral fees may harm the client by preventing referrals that would work to her benefit. There are some empirical studies of lawyer referrals that shed valuable light on the types of cases that are referred, but these studies do not address the welfare issues we focus on. See Stephen J. Spurr, Referral Practices Among Lawyers: A Theoretical and Empirical Analysis, 13 Law & Social Inquiry 87 (1988); Stephen J. Spurr, The Impact of Advertising and other Factors on Referral Practices, with Special Reference to Lawyers, 21 RAND J. Econ. 235 (1990).

3

The paper is organized as follows. In parts II and III, I describe the setting in which the referral problem arises and describe the framework I use to analyze the setting. The framework consists of a simple model of a referral under conditions of imperfect information. In part IV, I examine the economic functions served by referrals. My object there is to explore the extent to which the interests of lawyer and client are aligned in the referral process.

In parts V through VII, I then use this analysis to consider three sets of issues: (1) Under what conditions is a ban paid referrals desirable? (2) If lawyer-paid referrals are allowed, what arrangements are they likely to use, and how should they be regulated? (3) To what extent should the client pay a share of referral fees? Part VIII sums up the main policy conclusions.

Two disclaimers should be made at the outset. First, my touchstone for the desirability of a given state of affairs is the welfare of clients, measured by their expected recovery in litigation. I treat the referral problem as essentially one of solving a principal-agent problem between lawyers and clients. I do not consider other, broader measures of social welfare (which might, for example, involve reducing the recovery of plaintiffs in litigation).

4

Second, to the extent clients' welfare is advanced by prohibiting certain lawyer referral arrangements, I take no position on whether the prohibition should be imposed *by clients themselves* or by some *regulatory authority*. Whether clients have the ability to protect themselves in the market (as well as a regulatory authority can do so) is an issue that arises in many areas of professional regulation, not limited to the referral area. To the extent clients cannot effectively protect themselves, the analysis to follows can be thought of as directed to regulatory authorities.

II. THE REFERRAL PROBLEM

A. The Setting

An individual has some sort of monetary claim against another. She decides to seek the assistance of a lawyer in attempting to recover the money. Recovering the money will require effort by the attorney (in gathering information, writing briefs, negotiating with the other side, preparing for trial, and so forth); the more effort he puts into the case, and the better the quality of his work, the higher the expected recovery in

the case.[5]

There is a pool of lawyers who are available to represent the individual. (The pool might consist of all of the lawyers in the city who are willing to accept cases of this type.) In hiring a lawyer, the client's objective -- we assume -- is to maximize her net expected recovery in the case. She will incur some costs in hiring a lawyer, if only because the lawyer will charge a fee for his efforts.[6] The client's aim is to maximize the expected recovery net of these and any other costs of obtaining it.

B. Properties of the Market for Lawyers

Three basic properties, we assume, characterize the market for lawyers in this setting. Combined, these properties complicate the client's task of maximizing her net return from the claim. Let us briefly describe each.

1. Variation among Lawyers

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[5]This may be because the probability of success goes up, or because the amount recovered in the event of success goes up, or both. It makes no difference for our purposes.

[6]To be sure, the fee may be contingent in nature, so that the lawyer gets paid only from the proceeds of any recovery.

The first property is that lawyers in the pool vary in quality -- that is, different lawyers will generate different net expected recoveries for the client. For our purposes, we may assume that this is largely due to differences in lawyer productivity: a given quantity of effort (say, 100 hours' work) by one lawyer will not necessarily produce the same expected recovery as the same quantity of effort by another lawyer. These differences might reflect underlying differences in skill, training, experience, resources, or many other influences.

I should emphasize that by lawyer productivity I refer to any conceivable factor that may bear on the lawyer's output. For example, a given lawyer may be knowledgeable in a given field of law; he may have other similar cases, enabling him to reap economies of scale; he may have previous dealings with the defendant, enabling him to bargain more effectively; he may "know his way around" the court system in which the plaintiff's case will be heard; his firm may be well equipped with staff and library resources. These and many other factors might make this lawyer more productive than another lawyer (in the sense that the same investment of effort by each would yield different outputs).

Now, a lawyer's productivity does not alone determine the quality of the lawyer's performance from the client's perspective. The lawyer's

7

quality from her perspective also depends on how much effort the lawyer puts into the case, and how much of the recovery he takes as his fee. (To use a common metaphor: the client cares about how large a "pie" the lawyer will create with his labors, and how large a "slice" of the pie he will take). The fact that some lawyer j is more productive that another k does not necessarily mean the client is better of with j; she might be worse off with him, if he charges a much higher fee or will work substantially less hard than k.

The important point for our analysis is that in a market where lawyer productivity varies, however, it is likely that quality -- the combination of productivity, effort, and fee charged -- is likely to vary as well. Obviously, the extent to which this is true will itself vary across cases. (Differences in lawyer quality may show up more in complex product liability cases than in routine auto accident cases.) In addition, not all lawyers in the pool will have substantial differences among them. (Two product liability specialists with similar experience and caseloads may be indistinguishable in their productivity.)[7] To the extent lawyer productivity varies, the client's choice of lawyer matters; her net

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[7]On the other hand, both may be very different from a lawyer who has never before handled a product liability case.

8

expected recovery depends on whom she hires.

2. Information Concerning Lawyer Quality

The second property of the market concerns the acquisition of information about a lawyer's quality. We assume that a lawyer's quality is not directly observable; that it is costly for the client to acquire information about a lawyer's quality; and that a given lawyer's quality may be better known to some of his peers than to others.

To illustrate this, suppose the client has a personal injury claim. There are, say, 1,000 lawyers in town who might be willing to represent her. The client does not know anything about most of these lawyers. To the extent they vary in productivity, she does not know who the more productive ones are. To the extent they charge different fees, she does not know what fee (20 percent or 30 percent, say) will produce the greater net expected recovery for her. We assume the lawyers cannot simply "reveal" their relative quality -- their own productivity, how hard they will work, or the desirability of a given fee[8] -- through some directly observable trait. We assume, in addition, that lawyers cannot

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8Obviously lawyers have an incentive to exaggerate their productivity and to say that a large fee is best.

9

bond or warrant their quality by, say, promising the client a given outcome.

In this environment, the client will inevitably be imperfectly informed of lawyers' relative quality and, indeed, perhaps their identities. She can acquire some information at relatively low cost: she may get a few lawyers' names from friends or acquaintances; she may consult the yellow pages; she may contact some of the lawyers to find out their fees. By investing more time and effort, she can get still more information: she might interview different lawyers; she might research the track records of different lawyers; she might hire someone (such as a lawyer referral service) to track down a suitable lawyer.

Yet even after investing considerable time and effort in the search process, the client will still harbor some uncertainty about the relative quality some of the lawyers in the pool. Her search may have eliminated, say, all but ten of the lawyers in the pool; but within that subset, she is uncertain about which one would best handle her claim. She could invest still more to winnow out some of the ten, but this has diminishing returns; the optimal investment will probably leave her with some uncertainty about the relative quality of the lawyers in the subset.

Lawyers themselves, however, may have better information than

even a well-informed client has about the relative quality of a given lawyer. Suppose, for example, that the client's search leads her to some lawyer j ; the client's information tells her j is the best available lawyer. Lawyer j, however, believes that another lawyer, k, with whose work he is acquainted, would generate a higher net expected recovery for the client.

Lawyer j's information on this question may be much better than the client's. Lawyer j knows his own capabilities and how hard he will work on the case; he may in addition know things about k (that k is particularly good with this kind of case, that he handles many similar cases, or such) that the client does not. One can tell many plausible stories about why it may well be in the client's interest to defer to j's judgment (if she can obtain it) that for her case, k is the better lawyer than j.

The general point here is that lawyers often have a comparative informational advantage over clients in locating or identifying a suitable lawyer for a given case. This comes in part from knowing differences in productivity -- knowledge that comes from working with one another, following one other's activities in professional journals, socializing with

one another, and so forth.[9]   And it comes in part from knowing the appropriate fee for a case: all else equal, the more work the case will require to produce a given recovery, the higher the fee should be; this is a matter of guesswork, but the lawyer is likely to have a better idea than the client about it.

3.   Moral Hazard

The final pertinent feature of the market is that each lawyer generally acts to further his own interests.   In particular, in dealing own a client on a given case, the lawyer will seek to maximize his own net expected return from the case.   He works for the client's benefit only to the extent that the client's interests intersect with his own.   This assumption has two implications for the client.

First, it means that, in considering whether to refer the client's case to another lawyer, the lawyer will act to maximize his own return from the referral decision.   Thus, if he would earn a positive return on a case by acting as the client's lawyer, he will not refer the case to *another* lawyer (thereby giving up that positive return) unless he is paid for doing

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[9]Just as doctors are more likely than patients to know who the good surgeons for a given operation are, lawyers are more likely than clients to know (or find out at relatively low cost) who the good lawyers for a given case are.

so. In addition, in choosing whom to refer the case to, he will make the choice that maximizes his referral fee.

Second, in representing a client on a case, the amount of work the lawyer will do on the case depends on the economic rewards he stands to earn. The fee arrangement -- including any referral fees paid to another lawyer -- will thus be an important determinant in the amount of effort the lawyer invests in the case. Thus, if the case is referred from lawyer j to lawyer k, the amount of work k will put into the case will depend in part on how the proceeds from the case are divided between j and k.

C. The Client's Problem

The client faces the following dilemma in this market environment. On the one hand, lawyers are a useful source of information in her search for the best available lawyer. All else being equal, she would want to delegate to them (at least in substantial measure) the task of choosing a suitable lawyer for her. Their comparative informational advantage implies that they are better than she is at identifying the lawyer who would maximize her return from the case.

On the other hand, lawyers are concerned with maximizing their *own* return from the case, not (or not necessarily) the client's. Delegating to

lawyers the task of choosing an appropriate lawyer may make the client worse off (than making the choice herself), if the lawyers' rewards are structured in such a way as to create diverging lawyer-client interests. The client's problem, then, is to employ a system of rewards that (1) give lawyers an incentive (to the extent possible) to refer her to the best lawyer, and (2) enable the client to get the best possible performance from the lawyer who ultimately represents her.

In what follows, we will attempt to analyze the effects and desirability of different types of reward. I should emphasize that we are investigating not what reward systems actually (are likely to) emerge in equilibrium, but rather *what is optimal for the client.* We make no positive claims about whether the market is likely to generate the optimal outcome.

III. ANALYTICAL FRAMEWORK

A. The Model

To analyze the client's problem, let us employ the following simple model of a referral, whose sequence of events is depicted in Figure 1. Let me briefly describe each stage in the model.
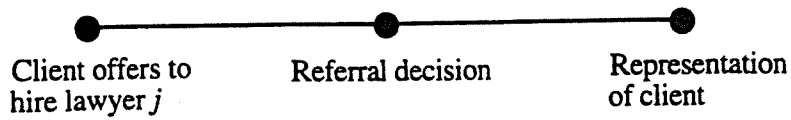
Client offers to Referral decision Representation
hire lawyer *j*   of client

FIGURE 1. — Sequence of events in the model.

At stage one, the client approaches some lawyer *j* and offers to hire him to handle her claim for money damages against the defendant. This comes after the client's own search for a lawyer, in which she has used whatever sources of information are available to her. The client's search indicates that *j* is (given her information) the best available lawyer for her case. However, she remains uncertain about the relative quality of *j* vis-a-vis (some) other lawyers.

Upon being approached by the client, lawyer *j* examines the case to assess its nature -- its chances of success, the work that will be

required, the expertise that will be useful, and so forth.[10] At stage two, having evaluated the case, j then decides whether to take the case himself or refer it to a different lawyer (drawn from the pool of lawyers $k, l, m...$). We assume that taking the case and referring it are mutually exclusive options; if he refers the case, he does no work on it. Lawyer j makes the referral decision that maximizes his own welfare.

At stage three, the lawyer who represents the client -- either j or the lawyer to whom the case is referred -- decides how much effort to invest in the case. The case is then resolved in some fashion (settlement, trial, arbitration, or whatever); the mode of resolution makes no difference to the analysis. The lawyer chooses the level of effort that maximizes his own welfare.

B. Assumptions

We make the following assumptions about the above setting.

1. The Value of the Claim

The value of the claim -- or the expected recovery in the case --

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10He might acquire this information by interviewing the client and a few witnesses, for example.

consists of the total expected amount paid by the defendant (weighted by the probability of recovery) We assume the expected recovery depends on a combination of three factors. (1) It depends on the "intrinsic" strength of the case -- fixed features such as the severity of her injuries, the nature of the evidence, and so forth. (2) It depends on the amount of effort put into the case by the lawyer. We assume that additional effort by the lawyer produces positive but diminishing returns. (3) It depends on the lawyer's productivity of effort. Though all lawyers's efforts produce positive returns, the magnitude of these returns (as noted before) may vary.

The relative importance of these factors may vary from case to case. In some cases, the intrinsic strength of the claim may be the dominant factor; in others, the amount of work put in by the lawyer; in others, the quality of the lawyer handling the claim.

2. <u>Differences among Lawyers and Claims</u>

We assume that lawyers may vary in either their productivity, the attorney's fees they charge, or both. Such differences are exogenously determined. Thus, we take a particular lawyer's productivity, and the attorney's fee he charges, as given.

Regarding the intrinsic features of the claim, we assume that these vary from claim to claim. For example, in some claims the evidence of liability is strong, in others weak; in some claims the amount of damages sustained by the client is great, in others small; and so forth. These intrinsic features are not necessarily readily observable; a lawyer may, we assume, have to do some investigating to determine the quality of the client's case.

3. Information

Regarding lawyer quality, we assume that a lawyer knows his own quality. In addition, j, the referring lawyer, knows the quality of any lawyer whom he considers referring the case to. The client, however, does not necessarily know the relative quality of j and other lawyers.

Regarding the intrinsic strength of the claim, we assume that this is known to j (who has examined the claim) and to the client. The lawyer to whom the case is referred, however, does not necessarily know the intrinsic strength of the claim.

IV. CONFLICTING FUNCTIONS OF REFERRALS

A referral may serve either (or both) of two potential functions. On

18

the one hand, a referral may improve the *client's* welfare by increasing

her net expected recovery from the case. On the other hand, a referral may

improves the *referring lawyer's* welfare by earning him a greater profit

than he would get if he handled the case himself. Our objective in this

section is to consider the relation between these two functions. To what

extent do they overlap or conflict? To what extent, that is, do the

referring lawyer's interests intersect with the client's in referring the

case?

This issue is critical, for the simple reason that the referring

lawyer (not the client) has primary control over the referral decision. If a

referral is not in his interest, he will not make the referral; if it is in his

interest, he will make the referral -- regardless of whether the referral

is in fact in the client's interests. A pressing question, therefore, is to

ascertain the extent to which the interests of lawyer and client coincide.

A. Lawyer-Paid Referrals

Let us suppose the client delegates to the lawyers the decision of

who shall represent her. We will assume that the client permits the

lawyers to strike whatever referral fee arrangement they like, but that

she does not pay any referral fee. We want to know the extent to which

the referral decisions j will make in this environment advance the client's welfare.

1. The Interests of Lawyer and Client

We begin by defining the conditions in which a referral is in the interests of lawyer and/or client. Whether a case will be referred generally depends on whether the referee lawyer will earn a greater profit from handling the case than would the referring lawyer. Thus, the touchstone for whether a referral will occur is whether it increases the joint profits of the participating lawyers. In contrast, whether a referral is *desirable* ,from the client's perspective, depends on whether it will lead to a larger net recovery for her.

We can compare the interests of lawyer and client more precisely with some simple notation. Suppose lawyer j is choosing between referring the case to lawyer k or instead keeping it himself. Let

X = Costs incurred by the lawyer who represents the client;

W = Expected recovery in the case resulting from the lawyer's efforts;

F = The amount collected by the lawyer as his attorney's fee.

We will use subscripts to designate the lawyer who represents the

20

client.[11]

Using this notation, we observe that the case will generally be referred if and only if

$$F_k - X_k > F_j - X_j.$$ (1)

When (1) holds, then k can handle the case more profitably than j; there is accordingly some mutually agreeable sum that k could pay j that, in yielding a referral, would leave both lawyers better off.[12] In contrast, the referral will be in the client's interest if and only if

$$W_k - F_k > W_j - F_j.$$ (2)

When (2) holds, the client earns a greater net recovery when she is represented by k.

These expressions define the conditions in which the client's interests will coincide with or conflict with the lawyer's on the referral question. If (1) and (2) both hold, then the referral will occur and the client will be better off as a result. Conversely, if neither (1) nor (2) holds, then the referral will not occur, and the client will again be better

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Thus, if j serves as the client's lawyer, then X_j denotes the costs incurred by j; W_j denotes the resulting expected recovery; F_j denotes the fee collected by j.)

[12]This statement may not hold if the lawyers are asymmetrically informed about the claim. I put this complication to one side here.

off as a result. In these two scenarios, lawyer's and client's interests are aligned.

A conflict of interest arises when only one of the above expressions is satisfied. If (1) holds but (2) does not, the referral will occur and make the client worse off as a result. Conversely, if (2) holds but (1) does not, the referral will not occur, and the client will be made worse off (than if the referral had occurred).

2. The Potential for Conflict

Expressions (1) and (2) thus define the circumstances in which the lawyers' interests align with, or fail to align with, the client's. They do not tell us, however, when such circumstances are likely to arise. To what extent are the interests of lawyers and client likely to be aligned in practice? How likely is it that (1) and (2) hold (or fail to hold) at the same time?

It is difficult to generalize. On the one hand, there is no necessary conflict between lawyer profits and client recoveries. It is sometimes possible to increase both at the same time: for example, giving the case to k may yield a greater client recovery *and* greater lawyer profits. On the other hand, there is no necessary compatibility between lawyer profits

and client recoveries. Giving the case to k may generate a lower client recovery but greater lawyer profits. There is no way of knowing a priori whether lawyer profits and client recoveries "move" in the same direction or in opposite directions.

A few examples can illustrate the point. Examples 1 and 2, contained in the tables nearby, illustrate how -- depending on the nature of the lawyers' productivity differences -- the client's interests may or may not intersect with the lawyers' on the question of who represents her. The examples depict a hypothetical case in which the lawyer representing the client works under the customary 33 percent contingent fee. In the examples, the lawyer can choose between two levels of investment (25 or 50);[13] the resulting expected recovery on the claim is different for the two lawyers, reflecting differences in their productivity.[14] The examples then indicate the lawyers' profits,[15] and the client's net recovery.[16]

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[13]Thus, X is either 25 or 50.

[14]Thus, the second set of columns indicate W_j and W_k.

[15]Given by $(.33)W_j - X$ and $(.33)W_k - X$, respectively.

[16]Given by $(1-.33)W_j$ or $(1-.33)W_k$, depending on who represents her.

EXAMPLE 1
EXPECTED RECOVERIES PRODUCED BY LAWYERS WITH DIFFERENT PRODUCTIVITY

Lawyer's Investment	Total recovery		Lawyer's profit		Client's net recovery	
	j	k	j	k	j	k
2 5	1 0 0	1 4 0	8	2 2 *	--	93
5 0	2 0 0	2 0 0	1 6	1 6	133*	--

NOTES. — The attorney's fee for either lawyer is assumed to be 33 percent. Asterisks indicate the maximum lawyer profit and client recovery, respectively. Dashes indicate that the corresponding investment will not be chosen by the lawyer, so that the client's net recovery is irrelevant.

In both examples, lawyer k earns a greater profit on the case than j; thus, the lawyers' joint interest is in having k take the case. In example 1, the client's interests conflict with the lawyers': she is better off being represented by j. The reason for this, in essence, is that lawyer k (given a 33 percent fee) will rationally choose to invest a low level of effort in the case.[17] In contrast, lawyer j (given that same 33 percent fee) will invest a high level of effort in the case. As the figures in example 1 make clear, the client does better with lawyer j.

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[17]The lawyer chooses whichever level of effort gives him the greater profit. As Table 1 indicates, k gets a higher profit by choosing the low level of effort.

EXAMPLE 2
EXPECTED RECOVERIES PRODUCED BY LAWYERS WITH DIFFERENT PRODUCTIVITY

Lawyer's Investment	Total recovery		Lawyer's profit		Client's net recovery	
	j	*k*	*j*	*k*	*j*	*k*
25	100	140	8	22	--	--
50	200	300	16	50*	133	200*

NOTE. — The attorney's fee for either lawyer is assumed to be 33 percent.

In example 2, however, no such conflict arises. Lawyer *k* will (if given a 33 percent fee) rationally choose to invest a high level of effort. Because the resulting recovery is so great, the client is better off in this example if she is represented by *k*.

The lesson of these examples is that, depending on the nature of lawyers' productivity differences, the lawyer's interests may or may not be aligned with the client's. I make no claim about the representativeness of these examples; it may be that, in practice, examples in which their interests coincide are more likely than examples in which their interests conflict (or vice versa). For now, it suffices to

note that, in a regime where lawyers are free to strike their own referral arrangements, there is no necessary correlation -- either positive or negative -- between the interests of the referring lawyer and the client.

B. Client-Paid Referrals

Let us now turn to settings where the referring lawyer may collect a referral fee from the client. Thus, assume that lawyer j and the client may strike a deal in which, for some payment from the client, lawyer j agrees to refer the client to lawyer k.[18] (The payment may consist of an up-front payment, or a share of the proceeds from the case.) To simplify the analysis, assume that j cannot collect a referral fee from the referee lawyer.

In this setting, as in the last, we will find that the interests of j and the client may, but do not necessarily, intersect on the question whether the case should be referred. Lawyer j will refer the case if his anticipated referral fee exceeds his anticipated profit from handling the case. When the client is uncertain about the relative quality of j and k, sometimes she will pay "too little" for a referral -- leading j to keep the

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18To assure payment, j may refuse to divulge k's identity until the referral arrangement is struck.

case even though this makes the client worse off. Sometimes, instead, the client will pay "too much" for a referral -- leading j to refer the case even though this makes the client worse off.

1. The Interests of Lawyer and Client

To express the relative interests of lawyer and client concerning a referral decision, we need the following additional piece of notation. Let

R = Referral fee client pays to lawyer j.

Using this notation, we see that lawyer j will refer the case to lawyer k if and only if

$$R > F_j - X_j. \qquad (3)$$

This expression says that the referral will occur if the referral fee paid by the client exceeds j's anticipated profit from keeping the case himself. In contrast, a referral to k will benefit the client if and only if

$$W_k - F_k - R > W_j - F_j \qquad (4)$$

If this expression holds, then the client's net recovery from hiring k (and paying a referral fee) is greater than his net recovery from keeping j.

27

These expression enable us to define the conditions in which the client's interests intersect with the referring lawyer's. On the one hand, if (1) and (2) both hold, or if neither (1) nor (2) holds, then their interests intersect. On the other hand, a conflict of interest arises if one expression but not the other holds.[19]

2. The Potential for Conflict

If the client knew the relative quality of j and k -- more precisely, if she knew the value of the terms in (1) and (2) -- then her interests would intersect with j's on the issue of whether a referral occurred. The reason, quite simply, is that *she would choose the referral fee* to ensure that j referred the case to k if, and only if, the referral worked to the client's net benefit. Thus, if there were some referral fee -- some value of R -- that could satisfy both (1) and (2), then the client would offer it to j; the referral would occur, leaving both the client and j better off. If, instead, there were no value of R that could satisfy both (1) and (2), then the client and j would agree that the case should not be referred.

19If (1) holds but (2) does not, then the lawyer will refer the case, but the client will be made worse off as a result. Conversely, if (2) holds but (1) does not, the lawyer will decline to refer the case, and the client will be made worse off (than if the case had been referred).

Suppose, however, that the client does not know the relative quality of j and k. In particular, suppose that the lawyers have no way of credibly revealing their relative quality to the client. Then the referral fee the client is willing to pay is necessarily *independent* of the lawyers' relative quality (because she does not know their relative quality).

In such circumstances, it is easy to see how the client's interests may conflict with j's on whether a referral occurs. In deciding what referral fee to pay, the client cannot "take j's word for it" that a given referral fee is worth paying.[20] If the referral fee the client is willing to pay is sufficiently great, then j will refer the case to k, whether or not the client is made better off as a result. If, instead, the referral fee the client is willing to pay is sufficiently low, then j will decline to refer the case, again whether or not the client is made better off as a result.

Examples 3 and 4 illustrate how, in this setting, j's may overlap or conflict with the client's on the referral question. Suppose there are two types of lawyer, "good" and "bad." Examples 3 and 4 indicate the lawyer profits and net client recoveries generated by each type of lawyer if he

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[20]Lawyer j has an incentive to make R as large as possible.

works on the case.[21]   We assume, for simplicity's sake, that the client

knows these numbers.   However, the client does *not* know a given lawyer's

type.   Lawyer *j* may be good or bad; lawyer *k* may be good or bad; the client

has no way of observing either's quality.

In both examples, the client wants (if possible) to encourage a

referral if and only if *j* is bad and *k* is good.   She does not want to

encourage a referral if *j* and *k* are the same type, for then she would

simply be wasting her referral fee.

EXAMPLE 3

Lawyer type	Lawyer's profit	Client's net recovery
good	3 0	1 2 0
bad	2 0	1 0 0

In example 3, the client can structure the referral fee so as to align

her interests with *j*'s -- that is, to ensure that *j* refers the case if and

only if the referral makes the client better off.   Suppose she offers *j* a

referral fee that gives *j*   one-sixth of the client's ultimate net recovery in

the case.   Then a referral will occur if and only if he is a bad lawyer and *k*

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[21]"Lawyer's profit" refers to the attorney's fee minus litigation costs ($F-X$); "client's net recovery" refers to the expected recovery minus the attorney's fee ($W-X$).

is a good lawyer. Thus, by offering that referral fee, the client can align her interests with j's on the referral issue.

In example 4, no such alignment is possible. If the client offers j one-sixth (or more) of her net recovery, j will refer the case even if he is a good lawyer. And if the client offers j less than one-sixth of her net recovery, he will decline to refer the case if he is a bad lawyer. No fee the client can offer will ensure that j refers the case if and only if he is bad and k is good.

EXAMPLE 4

Lawyer type	Lawyer's profit	Client's net recovery
good	1 5	1 2 0
bad	2 0	1 0 0

The difference between these two examples is that in example 3, lawyer profits and net client recoveries are positively correlated, whereas in example 4 they are negatively correlated.[22] This turns out to be crucial. When they are positively correlated -- that is, when lawyers

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[22]Examples 1 and 2 showed that this is possible, in principle.

who earn low net recoveries for clients also earn low profits, and vice versa -- then it is easier for the client to design a referral fee that aligns her interests with the lawyer's. In particular, she can offer a relatively low referral fee, knowing that *only "bad " lawyers will accept.*

In contrast, when lawyer profits and net client recoveries are negatively correlated, the client cannot do this. As example 4 shows, if she offers a high referral fee, then everybody will accept it; if she offers a low referral fee, only good lawyers (if anyone) will accept it. Thus, when lawyer profits and net client recoveries are negatively correlated, it is difficult if not impossible to design a referral fee that will align lawyer's and client's interests on the referral issue.

C. Lawyer Profits and Client Recoveries

1. Significance of the Correlation

We have examined two possible market regimes: one in which the referee lawyer pays for a referral, and one in which the client pays for a referral. Our object has been to see whether the lawyer's interests coincides with the client's on the question of whether her case should be referred. In both regimes, we have found that the answer depends on the correlation between lawyer profits and client recoveries.

That is, the question is whether an increase in *lawyer profits from representing the client* correlates to an increase in the *client's recovery.* If the two are positively correlated, then referral transactions (whether paid by client or by lawyer) may advance the client's welfare. If, instead, the two are negatively correlated, then referral transactions are likely to impair the client's welfare.

We can see the point as follows. Suppose that k can earn a greater profit from representing the client than j; using our earlier notation, suppose that

$$F_k - X_k > F_j - X_j. \qquad (5)$$

We want to know whether it is also true that k can earn a greater recovery for the client; in our notation, whether

$$W_k - F_k > W_j - F_j. \qquad (6)$$

Lawyer profits and client recoveries are "positively correlated" if the lawyer who earns the greater profit is also (more likely than not) the one who generates the greater expected recovery for the client. Thus, they are positively correlated if (6) holds when (5) does, and if (6) fails to hold when (5) fails to hold.

On the other hand, lawyer profits and client recoveries are

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"negatively correlated" if the lawyer who earns the greater profit is (more likely than not) *not* the lawyer who generates the greater expected recovery for the client. Thus, they are negatively correlated if (6) fails to hold when (5) holds, and if (6) holds when (5) fails to hold. Finally, lawyer profits and client recoveries are "uncorrelated" if the lawyer who earn the greater profit may or may not (with roughly equal probability) be the one who generates the greater recovery for the client.

The importance of determining what correlation, if any, exists between lawyer profits and client recoveries is easy to understand. It is, quite simply, because in either regime -- one in which lawyers pay referral fees, or one in which clients do -- cases are likely to wind up in the hands of the lawyer who can earn the greatest profit from representing the client. This is obviously true when lawyers are permitted to pay referral fees: when the lawyers are free to make trades between themselves, the case is likely to wind up in the hands of the one who values it the most. But it is also true when clients, rather than lawyers, pay referral fees: a lawyer who would earn a *low* profit from representing the client is more likely to accept a given referral fee than a lawyer who would earn a *high* profit.

The upshot is that, if lawyer profits and net client recoveries are

positively correlated, then in either regime lawyer and client interests are generally aligned on the referral question. If j would earn greater profits than k, he will handle the case; and the client will (because of the positive correlation) generally be better off as a result. In contrast, if the correlation is negative, then in either regime lawyer and client interests are generally opposed. If j would earn greater profits than k, he will keep the case; but (because the correlation is negative) the client would be better off if k handled the case.

2. Possible Correlations

The essential question, then, is how lawyer profits correlate to client recoveries in a market in which clients are unable to assess the relative quality of different lawyers We have seen that one can generate examples in which the correlation may be positive or negative. My purpose here is to identify some general conditions in which this is true.

To do this, let us consider the following two conditions. Suppose that, as between any two lawyers in the market,

(i) at all   levels of effort, one lawyer's marginal productivity exceeds the other's; and

(*ii*) the lawyers charge identical contingent fee percentages.

If both of these conditions are met, then there is definitely a positive correlation between lawyer profits and net client recoveries.[23] If, instead, one of these conditions -- either (*i*) or (*ii*) -- does not hold, then the correlation between lawyer profits and client recoveries may be positive or negative.

[FIGURE 2]

The meaning of condition (*i*) is illustrated in figures 2 and 3. In figure 2, one lawyer's marginal productivity of effort is greater than the other's *at all relevant levels of effort.*[24] In figure 3, by contrast, the lawyers' relative productivity depends on the amount invested: one lawyer has greater marginal productivity at low levels of effort; but then

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23More precisely, conditions (*i*) and (*ii*) are sufficient to ensure a positive correlation. I should emphasize that they are not *necessary* conditions; if (*i*) and (*ii*) do not hold, there may or may not be a positive correlation.

24As the figure is drawn, *k* has greater marginal productivity than *j*. Thus, the first unit of effort invested by *k* produces more than the first unit of effort invested by *j*; the second unit of effort invested by *k* produces more than the second unit of effort invested by *j*; and so forth.
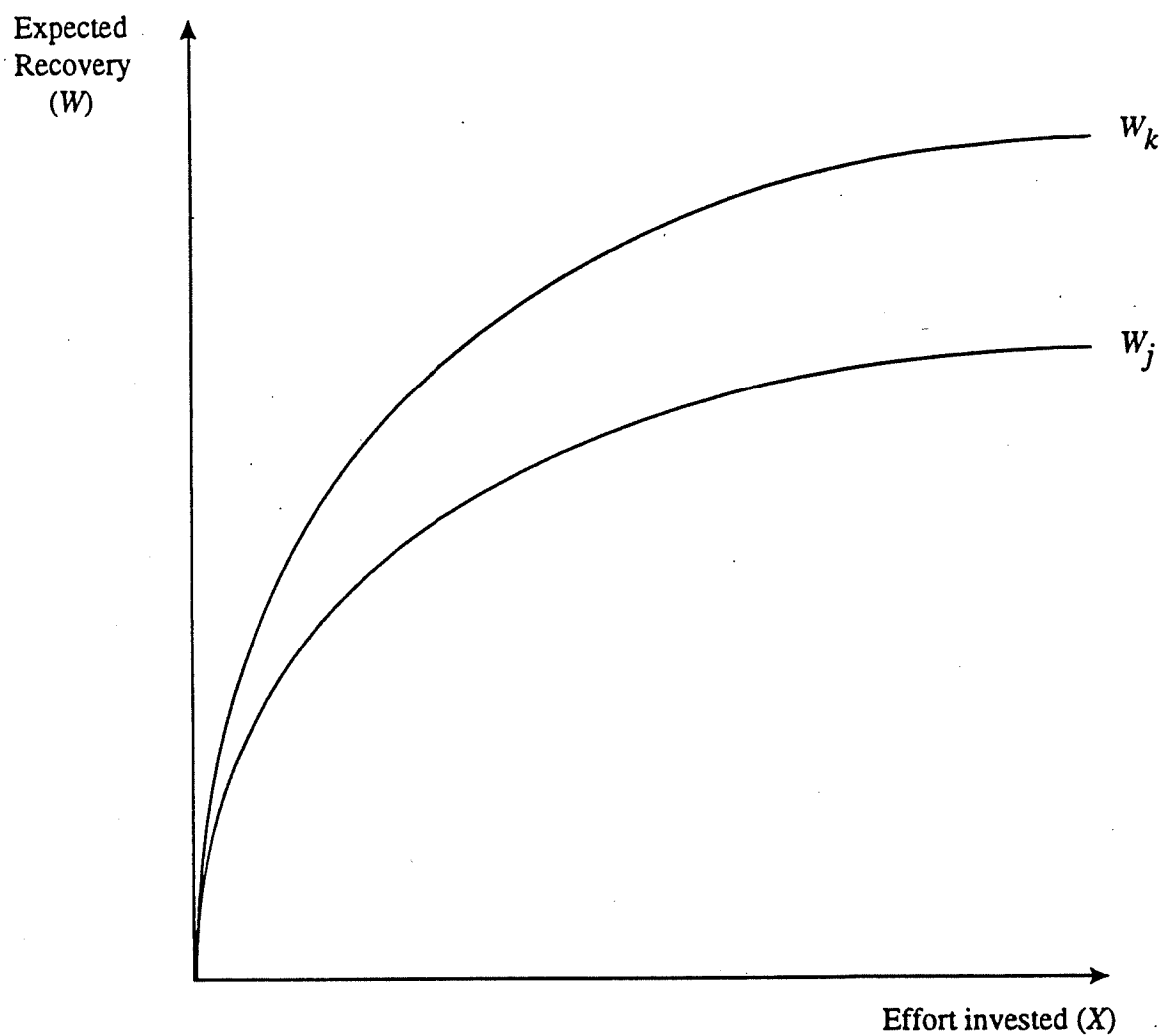
3 6

FIGURE 2 . — The slope of each curve at a given value of X represents the marginal productivity of effort at that value of X. As this figure is drawn, lawyer k has greater marginal productivity of effort than lawyer j at all relevant levels of effort.
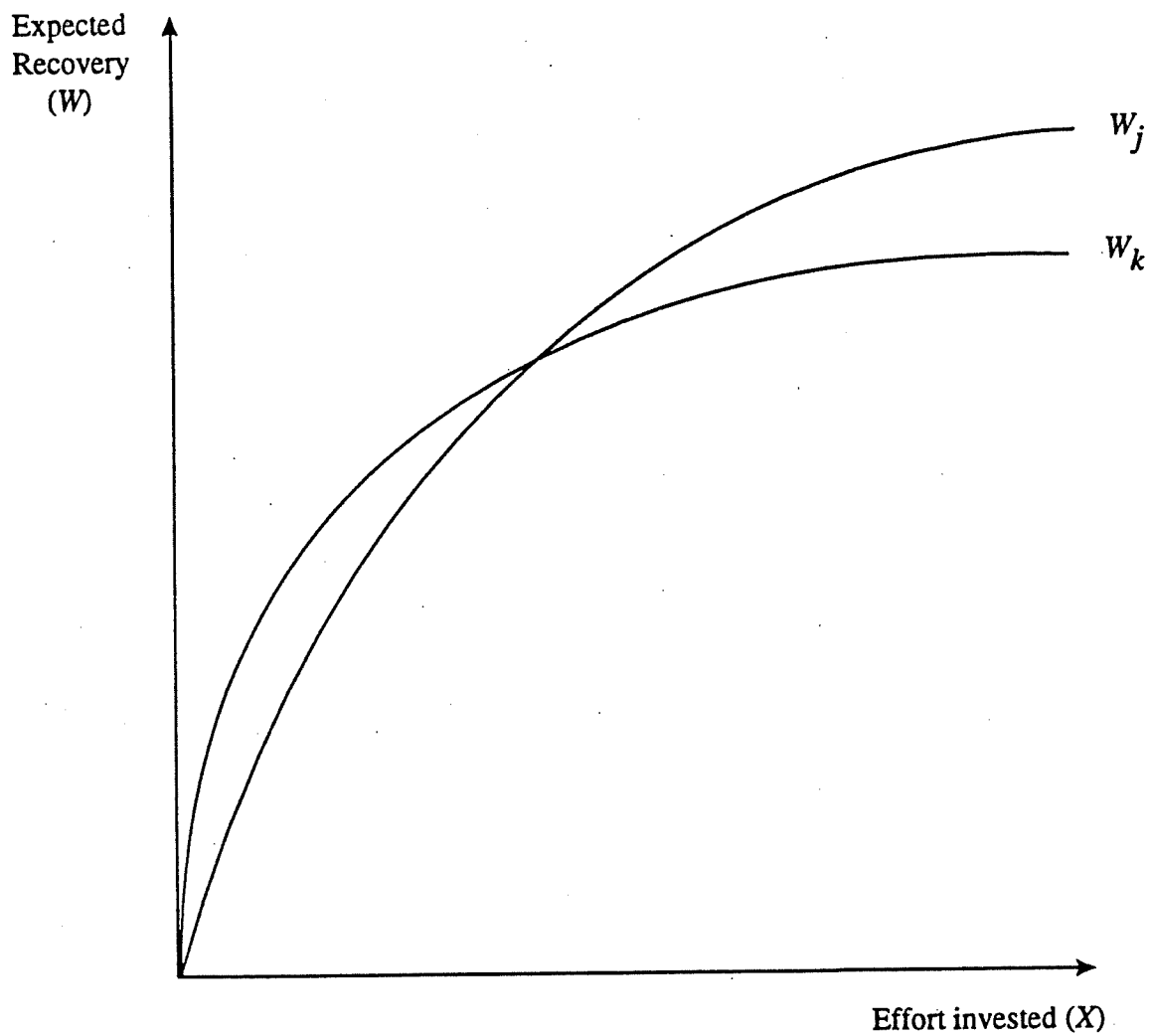
FIGURE 3 . — As this figure is drawn, one curve is steeper at relatively values of X, while the other curve is steeper for relatively high values of X. Thus, neither lawyer has greater marginal productivity than the other at all levels of effort.

diminishing returns set in quickly for him, so that the other lawyer has greater marginal productivity of effort at higher levels of effort.

[FIGURE 3]

It is straightforward to see why, if both conditions (*i*) and (*ii*) hold, the correlation between client recoveries and lawyer profits is positive. If both conditions hold, then the more productive lawyer will invest more in the claim, yielding a larger expected recovery, than the less productive lawyer.[25] As a result, the client is definitely better off having the case handled by the more productive lawyer.[26] The lawyers' joint profits are

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[25]To see this, observe that a lawyer will invest in the case up to the point at which his marginal product (multiplied by the fee percentage) equals the marginal cost of another unit of effort. Assume that k is the more productive lawyer. Let X_j represent the amount that j would invest in the case; at that level of investment, j's marginal product (multiplied by the fee percentage) is just equal to the marginal cost of another unit of effort. But by assumption, k's marginal productivity is greater than j's. It follows that, having invested the amount X_j, k will find that his marginal product (multiplied by the fee percentage) is still greater than the marginal cost of effort; so he will invest more effort than X_j.

Note, finally, that if k's marginal product is always higher than j's, then a given level of effort by k produces a greater expected recovery than the same level of effort invested by j. This, coupled with the fact that k invests more effort than j, suffices to show that the expected recovery by k will definitely be larger than that produced by j.

[26]Let p be the contingent percentage charged by each lawyer. We know from the previous footnote that $W_k > W_j$; it follows that $(1-p)W_k > (1-p)W_j$.

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also definitely larger if the case is handled by that lawyer.[27] Thus, in this case, the lawyer who generates the greater client recovery is also the one who earns the greater profit from the case, and vice versa.

This is not necessarily true, however, if either condition (*i*) or condition (*ii*) fails to hold.[28] If we relax either condition, there is no way of knowing a priori whether the correlation is positive or negative. For example, suppose that condition (*i*) fails to hold. Consider *j* in figure 3. Since his production function curve levels off so quickly, he will invest much less in the case than would *k*. His resulting profits may be bigger than *k*'s even while the resulting expected recovery is lower. There is no way of ruling this possibility out, if we relax condition (*i*).

Or suppose, instead, that (*ii*) fails to hold.[29] If the difference in fee percentages is sufficiently great, then the correlation between lawyer

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27This follows from the reasoning in footnote __ above. If *k* invested only X_j in the case, he would earn a greater profit in the case than *j* (because the investment is the same but the recovery is higher). The reason *k* invests more than that in the case is because his profits go still higher if he does so. It follows axiomatically that $pW_k - X_k > pW_j - X_j$.

28To be clear, I should note that the conditions in (*a*) are not necessary (though they are sufficient) for the alignment of lawyers' and client's interests. For example, (*a*) holds if, rather than charging the same contingent fee percentages, the lawyers charge the *optimal* fee percentages.

29In a market in which clients knew lawyers' relative productivity, we would expect the optimal attorney's fee to vary across lawyers. Absent that client knowledge, there is no reason to expect the market to yield (such) optimal attorney's fees.

profits and client recoveries may be negative. (This would occur if, for example, that the more productive lawyer charges a much higher fee percentage than the other.)   Here again, there is no way of ruling this possibility out, if we relax condition (*ii*).

Whether either condition (*i*) or (*ii*) generally holds in the market for lawyers is an empirical issue on which no one has collected data.   For present purposes, it suffices to note that the conditions do not *obviously* hold.   This is particularly true of condition (*i*): we have no way of saying that, in general, figure 2 depicts more accurately than figure 3 the differences between lawyers' production functions.[30]   As a result, it is debatable whether -- in a market where clients cannot discern the relative quality of different lawyers -- we should expect lawyer profits to be positively correlated with client recoveries

V.   BANNING PAID REFERRALS

Using this analysis, let us consider whether the client's interests are served by a prohibition on the payment of referral fees.   In particular,

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[30]In contrast, there is some reason to suppose that lawyers would charge the same contingent fee percentage in a market where clients could not identify their relative quality. See Bruce L. Hay, Bargaining and Search in the Market for Legal Services (unpublished manuscript, Jan. 1996).

consider a ban on lawyer-paid referral fees, and a ban on client-paid referral fees. (For present purposes, it makes no difference whether we think of the ban being imposed by the client herself,[31] or by some regulatory authority.) Would either type of ban (or both) be to the client's benefit?

A. The Prima Facie Case for a Ban

Assume j were prohibited from collecting any compensation (from the client or anyone else) for referring the case to another lawyer. Such a blanket prohibition would have the effect of preventing referrals altogether.[32] For if j could earn a positive profit by handling the client's case himself, referring the case would deprive him of this profit.[33] Unless he is paid at least the amount of that profit, he has no incentive to

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[31] She could simply refuse to pay any referral fee, and refuse her consent to any lawyer-paid referral.

[32] Except in instances where j acts out of motives other than self-interest.

[33] And even if j would (for whatever reason) not earn a profit by handling the case, he still has no incentive to refer the client to a good lawyer. Doing so might simply help give business to competitors. Several practitioners have told me their customary practice in such instances is simply to tell the client, "We cannot help you."

refer the case.[34] So no referral fees would mean no referrals.

Would this be a bad state of affairs, from the standpoint of client welfare? As our earlier discussion implies, it depends on the correlation of lawyer profits and client recoveries in the market for legal services. When referral fees are permitted, clients will generally wind up being represented by the lawyer who can earn the greatest profit from representing her. If the correlation between lawyer profits and client recoveries is positive, preventing paid referrals probably hurts the client, by making it less likely that the case will wind up in the hands of the lawyer who would generate the largest expected recovery for her. If the correlation is negative, preventing paid referrals helps the client for analogous reasons.

The desirability of a ban, then, turns on the empirical question of how lawyer profits and client recoveries are correlated. What if we are simply *uncertain* about the correlation? There is an argument that -- in the face of such uncertainty -- a ban on paid referrals is probably desirable from the client's standpoint. The argument, in essence, is that

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[34]Perhaps forms of compensation other than referral fees could be developed; in exchange for a referral from j today, lawyer k might agree to refer some business to j in the future. Not surprisingly, some jurisdictions that ban explicit referral fees also prohibit such quid-pro-quo referrals. See, e.g., California Rule of Professional Conduct 2-200(B).

the *transaction costs* associated with paid referrals work to the client's detriment; so unless there is a good reason to believe the *outcomes* of paid referrals will work to the client's benefit, there is no point in incurring these transaction costs.

In particular, the argument would go as follows. If lawyer profits and client recoveries are uncorrelated (or if we are uncertain about their correlation),[35] we have no reason to suppose that the outcome of paid referrals (the ultimate selection of a lawyer) would systematically yield better expected case results for clients. Some clients would obtain better results in their cases (than if no referrals had occurred); others would obtain worse results. The model gives us no basis for supposing either group would be larger than the other. On average, then, we would not expect the outcome of the referral process to generate neither gains nor losses for clients.

Second, the *referral process itself* would generate some costs which seem unambiguously bad for clients. Consider: the client offers to hire lawyer *j*; lawyer *j*, rather than (just) working on the case, devotes time and effort to seeking to refer the case, bargaining over the referral fee,

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[35]More precisely, if the "expected" correlation is zero -- that is, the correlation is as likely to be positive as negative.

seeking better offers, and so forth. The time and effort spent on seeking a referral do not, on average, work to the client's benefit (for reasons just seen); however, they may well harm the client, to the extent that j could have been devoting his energies toward winning a recovery for the client.[36]

In net terms, then, we might expect a system of paid referrals to work to clients' detriment: the process itself is costly to clients, in terms of diverted lawyer energies; and the value of the expected outcome of the referral process is neutral, on average. In general, then, we might suppose that clients would be better off if lawyer-paid referrals were banned entirely.

Reasoning of this sort might justify the widespread ban on referral fees paid by one lawyer to another. Notice, however, that the argument depends on the assumption that lawyer profits and client recoveries are not positively correlated (more precisely, that we have no reason to believe they are). As we saw previously,[37] if certain conditions hold, then the correlation is in fact positive, in which case a ban on paid referrals

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[36]This point holds with particular force when timing is an issue -- gathering evidence quickly, for example.

[37]See part III.B.3.

43

arguably harms clients. The important point for present purposes is that, granted sufficient uncertainty about the correlation, a ban on paid referrals is defensible from the standpoint of client welfare.

Notice, too, that this argument depends on the assumption that the client cannot ascertain the relative quality of different lawyers -- so that the client cannot control the referral decision in a way that maximizes her welfare. (This entails the assumption that the lawyers cannot reveal their relative quality to the client through some sort of bidding process.)[38] Suppose there are means by which a referee candidate can reveal his quality, so that a client can determine how the referral

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[38]One might imagine, for example, a hypothetical market in which lawyers could signal their quality by purchasing the claim outright from the client (or, equivalently, enforceably guaranteeing the client a given recovery). A competitive auction of this sort has some theoretical advantages for the client. The auction would be won by the lawyer who could make the most of the claim; the value of the claim itself would go up, because the principal-agent problems associated with divided ownership under the contingent fee would disappear; and the client would capture all of the rents, leaving none for the lawyer. (some of these advantages are discussed in Marc J. Shukaitis, A Market in Personal Injury Claims, __ J. Legal Stud. __ (1987).

The theoretical possibility of such an auction has little practical significance in most instances, however, for two reasons:

(1) There are search costs involved in securing bids from different lawyers. A lawyer would want to take a fairly close look at the claim before making a substantial irrevocable bid. Securing bids from all lawyers in the pool would then entail a fairly lengthy series of interviews and the like.

(2) There are difficulties in effecting an outright sale of the claim (or guaranteed recovery). Apart from being unlawful in most jurisdictions, they are also subject to problems of moral hazard (the client, having received payment, has no incentive to participate in the case; see Patricia Danzon, Contingent Fees for Personal Injury Litigation, 14 Bell J. Econ. 213 (1983)) and of adverse selection (the client would have an incentive to conceal unfavorable aspects of the case).

would affect her expected recovery. Having such information, the client could veto referrals that reduced her welfare, and consent to those that increased it. In such a setting, banning paid referrals would hurt her by depriving her of this choice.

B. The Choice Between Lawyer-Paid and Client-Paid Referrals

To this point, we have assumed that the ban would apply to both lawyer-paid and client-paid referrals. What about banning one but not the other?

The prima facie argument outlined above applies to both lawyer-paid and client-paid referral fees. That is: if the correlation between profits and recoveries is not positive, then allowing either type of referral fee is likely to make clients worse off than allowing no referral fees. If, instead, the correlation is positive, then allowing either type of referral fee is likely to make clients better off than allowing no referral fees.

In this line of argument, both types of referral fee "stand or fall together." The correlation (whether positive or negative) between lawyer profits and client recoveries may tell us whether both types of fee should be banned or neither should be; it does not tell us, however, whether one should be preferred over another. There may, indeed, be reasons for

preferring one over the other; but these do not emerge from the previous analysis.

To address this question, we need more information about how the client is likely to fare when one or the other type of referral fee is used. In the ensuing two parts of the article, we examine in more detail the mechanics of each type of referral fee arrangement.

VI. LAWYER-PAID REFERRALS AND THEIR REGULATION

Let us suppose that lawyer-paid referrals are permitted. (This might be because, in some settings, there is no effective means of preventing them: for example, lawyer k, having been referred the case, might agree to pay j for his "work" on the case, even though that work consists of nothing more than the referral.)[39] In this part we will examine the type of fee arrangement the lawyers will undertake; the resulting consequences for the client; and the effect produced if the client[40] regulates the terms of the referral fee arrangement (without banning it entirely).

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[39] I am told by practitioners that this is a common pretense for paying referral fees. Courts and disciplinary bodies seldom inquire into the relative work done by lawyers k and j.

[40] Or the state, acting on behalf of the client.

A. Structure of Referral Fees

Lawyers have two basic referral fee instruments available to them: (1) an *up-front payment* arrangement in which the referee lawyer gives (or promises) the referring lawyer a fixed dollar amount at the time of the referral; and (2) a *contingent share* arrangement in which the referring lawyer gets some specified fraction of the amount the referee lawyer ultimately recovers from the case.

The lawyers may (absent regulation) choose any mix of the two instruments. (Thus, for example, a referral fee might give the referring lawyer a payment of $10,000 plus a 20 percent share of the attorney's fee ultimately recovered by the referee lawyer.) The lawyers' problem in choosing referral terms is to select the right mix of up-front payments and contingent shares. The client's problem in regulating referral terms is to figure out what payment structure she should allow the lawyers to use. In what follows, we will investigate the equilibrium decisions made by the lawyers, and then investigate the potential role for regulation.

B. Equilibrium Decisions

We begin by considering the fee arrangements that will be chosen in

47

equilibrium between referring lawyer and referee lawyer. We then consider how (in light of the fee he will get) the referring lawyer will select a referee from a pool of potential candidates.

1. Fee Arrangements

Suppose j wants to refer the case to some lawyer k. If the lawyers are free to use any fee arrangement they choose, what fee arrangement will they select? The answer depends on their relative information about the claim, as follows: (a) If informational asymmetries between the lawyers are sufficiently small, then the referral fee will take the form of a simple up-front payment, with no contingent share. However, (b) If informational asymmetries are substantial, then the referral fee will generally give the referring lawyer a contingent share in the claim.

This result reflects a dilemma facing the lawyers. On the one hand, giving j a contingent share creates a deadweight loss for the lawyers because it reduces k's incentive to invest in the claim; all else equal, the lawyers' gain from the referral are greatest when j's fee takes the form of an up-front payment. On the other hand, k will be reluctant to make a big up-front payment if j has private information about the claim; trade may be impossible unless (part of) j's compensation takes the form of a

48

contingent share.

Accordingly, the referral fee is likely to involve a contingent share if, and only if, *j* has substantial private information about the claim.[41] To see the point, observe first that the greater *k*'s share of the claim, the more *k* will invest in the case -- and the larger the resulting expected recovery will be.[42] Therefore, the lawyers' joint recovery is greater when they use a simple up-front payment than when they use a fee structure giving *j* a contingent share of the claim. For giving *j* a contingent share dampens *k*'s incentive to invest in the claim; in contrast, a simple up-front payment, being a sunk cost to *k*, will have no effect on his incentive to invest in the claim.[43]

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[41]The dilemma is analogous to that facing lawyer and client in constructing an appropriate attorney's fee arrangement when the client may be privately informed about the quality of her claim. The result we reach here is analogous to Rubinfeld and Scotchmer's demonstration that if clients are not privately informed, the optimal fee arrangement consists of a simple outright sale of the claim (an up-front payment leaving the client no share of the amount recovered from the defendant); but if clients are privately informed, the optimal fee arrangement generally gives the client a fractional share of the amount recovered from the defendant. See Daniel Rubinfeld and Susan Scotchmer, An Economic Analysis of Contingent Fee, __ RAND J. Econ. __ (1994).

[42]This is true anytime (as we have assumed) additional effort by the lawyer produces positive but diminishing returns. See Bruce L. Hay, Contingent Fees and Agency Costs, __ J. Legal Stud. __ (1996).

[43]For example, consider two scenarios. In scenario 1, the lawyers use a referral fee arrangement giving *j* one-third of the attorney's fee ultimately collected by *k*. Then, for every dollar of attorney's fees obtained in the case, *k* only gets 66 cents. In contrast, in scenario 2, the referral fee arrangement gives *j* no contingent share in the claim. Then, for every dollar of

The upshot is that, all else equal, the lawyers will prefer using a referral fee arrangement that consists exclusively of an up-front payment. However, if k is uncertain about the value of the claim, then a simple up-front payment arrangement may not be mutually satisfactory for the lawyers. Suppose the quality of the case falls on a continuum from "good" to "bad";[44] in good cases, k has large earnings and profits; in bad cases, he does not. ("Gross earnings" means the total dollar amount of attorney's fees; "profits" means gross earnings minus the lawyer's cost of working on the case.) Suppose, in addition, that lawyer j, but not k, knows where the case lies on this continuum. Suppose, finally, that j cannot directly reveal to k the quality of the case to k.[45]

In such a setting of asymmetric information, the lawyers are likely to employ a contingent share arrangement, as a mechanism by which j in effect partially "bonds" or warrants the quality of the case. To see this, suppose the case is on the "good" end of the continuum. If lawyer k knew

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attorney's fee obtained in the case, k collects the entire dollar.

Lawyer k will invest more in the latter scenario. At a certain point, k will reach the point at which, say, generating an additional dollar's worth of attorney's fees requires an investment of 70 cents. He will make that investment in scenario 2, but not in scenario 1.

44In good cases, the evidence favoring the plaintiff is strong, and the damages are enormous. In bad cases, the evidence favoring the plaintiff is weak, and the damages are small.

45We discuss below why such information transmission may not be possible.

this, he would be willing to make a large up-front payment reflecting the large profit he expected to earn on the case. Not knowing the case's quality, however, he will only be willing to make a small up-front payment (because the case may be bad). Lawyer j , knowing the quality of the case, will not settle for such a relatively small up-front payment; instead, he will opt for a contingent share in the gross earnings from the case.

Example 5 gives a simple numerical illustration. Assume there are only two types of claim (good or bad);and suppose the lawyers can either use a contingent share of 33 percent or an up-front payment. Example 5 indicates k's gross earnings, and profits, if the case is good or bad; we assume these are smaller (because he invest less in the case) if j has a contingent share.

EXAMPLE 5
RETURN GENERATED BY LAWYER k UNDER DIFFERENT REFERRAL ARRANGEMENTS

Type of return	Good claim		Bad claim	
	Contingent share	No contingent share	Contingent share	No contingent share
Gross earnings	100	130	50	75
Profits	50	65	20	25

NOTE. — "Gross earnings" refers to the dollar amount of the attorney's fee recovered.

51

"Profits" refers to gross earnings minus the cost of k's effort in the case.

With these figures in mind, suppose that the case is "good," but that
only j (not k) knows this.   Assume that half the cases in the world are
good, so that k puts a 50 percent value on the probability that the case is
good.   In this setting, the lawyers will rationally settle on a contingent
share of 33 percent rather than using an up-front payment.[46]   Only if the
case is "bad" will the lawyers agree to a simple up-front payment.[47]

The lesson of this example is that j, being privately informed about

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[46]On the one hand, k -- who believes that the probability the claim is good is one in two
-- will be indifferent between giving j an up-front payment of 30 and giving him a contingent
share of 33 percent.   To see this, observe that if he pays an up-front fee of and gives no
contingent share, then his expected profit -- net of the referral fee -- is $(.5)(65)$ +
$(.5)(25) - 30 = 10$.   If he gives a contingent share of 33 percent, then his expected profit --
again, net of the referral fee -- is $(.5)[(.66)(100) - 50] + (.5)[(.66)(50) - 30] = 10$.
Thus, the biggest up-front payment k will make (in lieu of giving a 33 percent contingent
share) is 30.

On the other hand, j -- knowing the claim is good -- will get $(.33)(100) = 33$ from a
contingent share of 33 percent.   Thus, the least he will accept in lieu of an up-front payment is
33.

Accordingly, there is no up-front payment that is mutually preferable to a contingent
share of 33 percent.

[47]As seen in the previous footnote, k -- who believes that the probability the claim is
good is one in two -- will be indifferent between giving j an up-front payment of 30 and giving
him a contingent share of 33 percent.

As for j, he -- knowing the claim is bad -- will get $(.33)(50) = 17$ from a contingent
share of 33 percent.

Accordingly, any up-front payment between 17 and 30 will make the lawyers better off
than a contingent share of 33 percent.

52

the case, in effect signals the quality of the case by the referral fee structure he is willing to accept. The poorer the quality of the case, the more j will prefer an up-front payment to a contingent share. Thus, if j is unwilling to accept a contingent share as his referral fee, then k can infer the case is relatively bad, and accordingly will make only a small up-front payment -- which reinforces j's incentive to accept a contingent share unless his claim is indeed bad.

This kind of logic suggests that, in equilibrium, only the worst cases will involve a simple up-front payment.[48] For in any case that is *better* than the worst case, j will want to signal this fact by agreeing to a contingent share. Once again, if j refuses to accept a contingent share, k will rationally conclude that the case is the worst possible -- and will offer an up-front payment so small that j will accept only if the case is indeed the worst possible. For this reason, all or nearly all referrals are likely to involve a contingent share.

Now, this discussion assumes that j has no way of credibly revealing the quality of the claim to k (except by agreeing to a contingent share).

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[48]This is an instance of the unravelling effect. For discussions of this effect in other contexts, see Bruce L. Hay, Civil Discovery: Its Effects and Optimal Scope, __ J. Legal Stud. __ (1994); Sanford Grossman, The Informational Role of Warranties and private Disclosure about Product Quality, 24 J. L. & Econ. 461 (1991).

How often this assumption holds is debatable. Where j and k have no ongoing business relationship, the assumption makes sense. On the one hand, j will be reluctant to send the client to k (or give too many details of the case to k) without a contract in place, for fear that k will in effect "steal" the client without paying a fee.[49] On the other hand, k will be reluctant to "take j's word for it" on the value of the case, since obviously j has an incentive to inflate its value if doing so will lead to a large referral fee. Thus, when there is no ongoing relationship for the lawyers to preserve, it is fair to speculate a contingent share would be used in most cases.

Information sharing is obviously easier if the lawyers have an ongoing relation to maintain. Lawyer k has less incentive to steal the client without paying a fee; lawyer j has less incentive to exaggerate the claim's value; for either type of breach of trust would jeopardize future profitable dealings between the lawyers. In such instances, j can credibly reveal the quality of the case directly to k; thus the lawyers will in effect be symmetrically informed about the case, so that the model would predict that the lawyers would not generally employ a contingent share.

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[49]Lawyer j would not want to put the client and k in touch without a referral contract in place; for the client and k have a joint incentive to "cut out the middleman" by simply agreeing to an arrangement in which k represents the client and no referral fee is paid.

2. Selection of a Referee

Let us now examine *j*'s choice of a referee lawyer. Assume he could refer the case to any of a number of lawyers. We want to know how he will make his choice in light of his anticipated referral fee arrangement. We can summarize our main result as follows: (*a*) If the anticipated referral fee consists primarily of an up-front payment, the case will generally be referred to the lawyer who would have the greatest *profit* in the case. That is, if *j* expects the referee lawyer to pay a simple up-front fee, then he will seek to refer the case to the lawyer who will have the largest profit in the case. (*b*) If the anticipated referral fee consists primarily of a contingent share, the case will generally be referred to the lawyer who would have the largest *gross earning* in the case. That is, if , *j* expects the referral fee to consist mostly of a contingent share, he will generally seek to refer the case to the lawyer who will have the largest gross earning in the case.

The intuition behind this result is simple. On the one hand, suppose the market for referrals is such that referral fees consist exclusively of an up-front payment. (This might be because this is the optimal arrangement for the lawyers; or it might be because this is the

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arrangement they are required to use by the client or some regulatory authority. It makes no difference for present purposes.)[50] In such a market, the highest bidder for the case will generally be the lawyer who would earn the greatest profit on the case.[51] The case will accordingly wind up being referred to that lawyer.

On the other hand, suppose that the market is such that referral fees consist exclusively of a contingent share, with no up-front payment.[52] In such a market, j maximizes his return from the case by referring it to the lawyer who would recover the most money as his attorney's fee (because j gets a specified fraction of that money). The referee lawyer's profit as such does not matter; what matters is the size of the gross attorney's fee.

EXAMPLE 6
RETURN GENERATED BY REFEREE LAWYERS UNDER DIFFERENT REFERRAL ARRANGEMENTS

[50]What we want to know is how lawyer j will make his choice of referee in a given market environment; we do not investigate here how that market environment comes into being.

[51]An exception would occur if some lawyers have better information than others. For example, suppose that j can credibly disclose a case's quality to k but not to l (because he has an ongoing relationship with k but not l). If the case is of high quality, k (knowing this) may bid more than l (who has no way of knowing the case's quality).

[52]Again, this might be because this is the optimal fee arrangement for the lawyers, or because they are required to use this arrangement by the client or some regulatory authority. It makes no difference.

Type of return	Lawyer k		Lawyer l	
	Contingent share	No contingent share	Contingent share	No contingent share
Gross earnings	100	150	120	150
Profit	50	75	45	50

Example 6 gives a numerical illustration. Suppose referral fees consist of a simple up-front payment. Lawyer k generates the larger profit, and so will bid more for the case. Suppose, instead, that referral fees consist exclusively of a contingent share (say, 33 percent). Lawyer l generates the larger gross earnings; accordingly, j gets more by referring the case to l.

In this discussion we have assumed that the referral fee is either an up-front payment or a contingent share (not a combination of both). In markets where a mixture of the two is used; the analysis is more complicated; depending on the relative prominence of the two components,[53] the case may be referred to either the lawyer who (given the fee arrangement) earns the greater profit or the lawyer who (given the

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[53]Here I refer to what fraction of the fee consists of an up-front payment and what fraction consists of a contingent share.

fee arrangement) earns the greater attorney's fee. The more the

arrangement relies on an up-front payment, the greater the tendency of j

to refer the case to the lawyer who earns the larger profit; the more the

arrangement relies on a contingent share, the greater j's tendency to refer

the case to the lawyer who earns the greater attorney's fee.

C. Effects of Regulation

Having investigated the equilibrium behavior of the lawyers, let us

turn to the effect produced if the client (or the state) regulates the terms

of the referral arrangement -- that is, the lawyers' use of an up-front

payment or a contingent share. As we know from part III, the lawyers'

interests are not necessarily congruent with the client's; there is no

reason, therefore, to expect that the unregulated outcome -- leaving the

lawyers free to choose whatever fee arrangement they want -- will be

optimal from the client's standpoint. The question, then, is how the

client's welfare is affected by regulation of the referral fee arrangement.

The central dilemma facing the client is as follows. On the one

hand, the lawyers' use of a contingent share dampens the referee lawyer's

incentive to invest effort in the case. (In contrast, an up-front payment

has no effect on the referee lawyer's incentive to invest effort.)[54] As a result, all else equal the client's net expected recovery is greater if the referee lawyer does not give a contingent share to the referring lawyer. On the other hand, the lawyers' use of a contingent share may have a desirable impact on the referring lawyer's choice of a referee lawyer. The prospect of earning a contingent share may induce the referring lawyer to seek out the referee who is, from the client's standpoint, the highest-quality lawyer. This desirable property is less present when the lawyers use a simple up-front payment.

Thus, two factors tug in opposite directions. The client wants to encourage a referral to the best possible lawyer; this is best achieved by requiring the lawyers to use a contingent share arrangement. But the client also wants to encourage hard work on the part of the referee lawyer; this is best achieved by requiring the lawyers to use a simple up-front payment.

Why does the use of a contingent share improve the referring lawyer's selection of a referee? There are two basic reasons.

First, as we saw in the previous section, when simple up-front

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54Once again, an up-front payment, being a sunk cost at the time the referee decides how much work to invest in the case, has no effect on his decision. See note __ above.

payments are used, j will seek to refer the case to the lawyer who will have the highest profit; in contrast, when contingent shares are used, j will seek to refer the case to the lawyer who will have the highest gross earnings. Client welfare is probably more highly correlated with gross earnings than with profits.[55] As a result, in general the client does better if j seeks out the lawyer who stands to have the largest gross earning in the case.

The point may be seen as follows. Suppose k and l charge the same contingent fee percentage as their attorney's fee.[56] Then the lawyer who has the higher gross earnings is also *necessarily* the lawyer who earns the greater net recovery for the client.[57] In contrast -- as we know from part III[58] -- the lawyer who has the higher profit may or may not be the lawyer who earns the greater net recovery for the client. Thus, in this setting,

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[55]This is not to deny that there may be a positive correlation between the client's welfare and lawyer profits. My claim is simply that the correlation between the client's welfare and gross lawyer fees is usually even higher.

[56]For example, each might charge the customary 33 percent contingent fee.

[57]The point may be seen with some simple algebra. Let p be the contingent fee percentage charged by each lawyer. If $pW_k >$ let pW_l, it follows that $(1-p)W_k > (1-p)W_l$.

[58]See supra part IIIC.

there is definitely a positive correlation between gross lawyer earnings and client welfare; but there is no obvious correlation (positive or negative) between lawyer profits and client welfare.[59]

Second, informational asymmetries vary between different lawyers. Suppose that l is the better lawyer (from the client's perspective) than k. Suppose, however, that k knows the quality of the case, while l does not. (This might be because j can credibly disclose information about the case to k, but not to l.)[60] Then k might make a bigger up-front payment than l, thus perhaps leading the case to be referred to k, even though the client might be better off with a referral to l.

For both of these reasons, the client will be tempted to compel j (if the market does not already compel him) to take a contingent share as his referral fee -- for this will induce him to refer the case to the lawyer

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[59]Suppose, instead, that k and l charge different contingent fee percentages as their attorney's fee. Then the lawyer who has the higher gross earnings may or may not be the lawyer who earns the greater net recovery for the client; so too with the lawyer who has the profit. In this setting, there is no obvious correlation (positive or correlation) between gross lawyer earnings and client welfare, or between lawyer profits and client welfare.

Thus, client welfare is not obviously correlated with either gross lawyer earnings or lawyer profits, except in markets where the lawyers charge the same contingent fee percentage -- in which event there is strongly positive correlation between client welfare and gross lawyer earnings. All else equal, therefore, the client would generally prefer that j refer the case to the lawyer who has the highest gross earnings in the case.

[60]Perhaps j has an ongoing business relationship with k but not with l. See supra note ___.

who would have the highest gross earnings in the case. The downside of doing so, however, is that the referee lawyer will invest less effort in the case than he would if the referral fee consisted (in part or in whole) of an up-front payment.

The client is forced, therefore, to make a trade-off between lawyer quality and lawyer investment -- that is, between having the case referred to the highest-quality lawyer and inducing the referee lawyer to invest effort in the claim. The first factor favors requiring the lawyers to use a contingent share; the second favors requiring them to use a simple up-front payment. Depending on the relative importance of the factors, the client may be better off requiring one or the other.

Examples 7 and 8 illustrate the point. Let us suppose that, if a simple up-front fee were employed, j would refer the case to k; but that if a contingent share were employed, j would refer the case to l. (The difference here would be attributable to differences in the lawyers' gross earnings and profits.) Lawyer l is the higher-quality lawyer from the client's perspective;[61] but the only way j will refer the case to l is if a contingent share is used, which means the lawyer will underinvest in the

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[61] Under either type of referral arrangement, l generates more for the client than k.

claim.[62]

EXAMPLE 7
CLIENT'S NET RECOVERY UNDER DIFFERENT REFERRAL ARRANGEMENTS

Referee	Referral fee arrangement	
	Contingent share	No contingent share
Lawyer k	125	150
Lawyer l	175	200

In example 7, the difference in the two lawyers' quality is sufficiently great that the client is better off having the case referred to l.[63] Even though l's greater quality is "wasted" to some extent because of the contingent share,[64] this waste is worth incurring from the client's perspective. In contrast, in example 8, the client is better off having the case referred to k: the difference in the lawyers' quality is not

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62That is, he will invest less than he would if no contingent share were used.

63g the case to l (with a contingent share) yields 175 for the client; giving the case to k (with no contingent share) yields only 150.

64If it were not for the contingent share, l would generate a net recovery of 200 for the client.

sufficiently great to justify the underinvestment produced by a contingent share arrangment.[65]

EXAMPLE 8
CLIENT'S NET RECOVERY UNDER DIFFERENT REFERRAL ARRANGEMENTS

Referee	Referral fee arrangement	
	Contingent share	No contingent share
Lawyer k	100	1 5 0
Lawyer l	125	2 0 0

The problem facing the client, then, is to determine which is more important -- differences in lawyer quality, or differences in lawyer effort. That is, she must choose between inducing a referral to the higher-quality lawyer, or encouraging the referee lawyer to invest effort in the claim. Presumably the relative importance of these factors will vary across cases. If quality is more important factor (in relation to effort), the more she will benefit by requiring the use of a contingent share arrangement. The more important effort is (in relation to quality),

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65A referral to k yields 150 for the client; a referral to l yields only 125.

the more she will benefit by instead prohibiting the use of a contingent share.

VII.   CLIENT-PAID REFERRALS

We turn now to client-paid lawyer referrals. We will examine the following issues: why clients might want to pay referral fees; the optimal form of the referral fee; and the extent to which the referral optimal referral fee arrangement has the client, the referee lawyer, or both pay the referral fee.

In examining these questions, it is helpful to begin by observing that the client may pay a referral fee in one of two ways. The client may simply pay the referral fee directly to the referring lawyer. Alternatively, she may compensate the referee lawyer for (all or part of) the referral fee paid by the referring lawyer. These two forms are interchangeable, in the sense that any referral fee the client could make *directly* to the referring lawyer she can also make *indirectly* -- through the referee lawyer -- with no change in the welfare of either the client or the lawyers.

A simple example will make the point. Suppose lawyer j is referring the case to lawyer k. The following two referral fee arrangements are

equivalent from the standpoint of j, k, and the client. In the first arrangement, lawyer k gets a 33 percent contingent fee; the client pays j 10 percent of her net recovery as a referral fee; k pays no referral fee. In the second, lawyer k gets a 40 percent contingent fee; lawyer k pays j a referral fee equal to one-sixth of the attorney's fee; and the client pays no referral fee. The end result of the two arrangements is identical; the only difference is that in the second, k pays the referral fee and then in effect gets paid back by the client.[66] As we examine client-paid referrals, this interchangeability of direct and indirect payments should be kept in mind.

A. Why Client-Paid Referrals?

Why would it ever be in the client's interest to pay a referral fee? Shouldn't the client just let the referee lawyer bear the costs of the referral? Suppose k would generate a larger net recovery for the client than j. Then (if lawyer profits and client recoveries are correlated) it is also true that lawyer k will earn a greater profit from representing the

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66Observe that .33 = .4 - .16, so that the two arrangements are equivalent from k's standpoint. As a result, the expected recovery on the claim will be the same under either arrangement (because k will invest the same amount of effort under either arrangement). It is then easily verified that (.1)(.67) = (.16)(.4), so that j is indifferent between the two arrangements; and that (.9)(.67) = .6, so that the client is different between the two arrangments.

client than will lawyer j. Accordingly, lawyer k should be willing to pay a sum large enough to induce j to refer the case. Why should the client help pay for the referral if she can have it for free?

The answer is that referrals, like lunches, are not free. On the one hand, it may be impossible to force k to pay the full referral fee. Having paid the referring lawyer, k may simply pass on the costs to the client by raising his attorney's fee. In this manner, the client may be forced indirectly to pay some or all of the referral fee.

On the other hand, even if it is possible to compel k to pay the full fee, the client will end up incurring some costs. Suppose that -- for whatever reason -- lawyer k is prevented from passing on costs of the referral by adjusting his attorney's fee. (This might be due to professional regulation.)[67] Then k will work less hard on the claim, yielding a smaller net recovery for the client.

This observation follows from our discussion of contingent shares in the previous part. If k gives j a contingent share of his attorney's fee, he will invest effort in the case than he would otherwise. Thus, for example, suppose k's attorney's fee gives hims, say, 33 percent of the recovery in

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[67]Some disciplinary rules permit the referee lawyer to pay a referral fee, but prohibit him from raising his attorney's fee for the purpose of recouping the referral fee. See, for example, California Rule of Professional Conduct 2-200(A)(2).

the case. If he must give a portion of that fee to *j*, his effective

attorney's fee will be less than 33 percent. As a result, he will invest

less in the case -- and less will be recovered -- than if his effective

attorney's fee were 33 percent.

Now, it may or may not be in the client's interest to counteract this

effect by raising *k*'s attorney's fee, in order to compensate him for the

referral fee he has paid. That is an issue we take up below. The important

point for present purposes is that the client "pays" in one way or another

for lawyer-paid referrals. In particular, she must choose between either

(1) contributing to the referral fee, either directly or by defraying the fee

paid by the referee; or (2) having the referee work less hard on the case

(than he would if the client had contributed).

B. The Structure of the Referral Fee

Assume that the client decides to contribute to the referral fee.

How should she do so? In principle, the same two fee instruments are

available for client-paid referrals as for lawyer-paid referrals: an up-

front payment or a contingent share that gives the referring lawyer a

specified fraction of the client's recovery. However, it is not difficult to

see that, as between the two, the contingent share is likely to be the

preferable instrument. This is true even if the client has the resources (she often does not) to make an up-front payment.

The reason for preferring a contingent share is that it encourages the referring lawyer to refer the case to the best possible lawyer. If the quality of referee lawyers varies, and the client cannot determine the quality of a given referee lawyer, it would be a mistake for her to pay a referral fee consisting of a simple up-front payment. The referring lawyer would be indifferent about the quality of the referee lawyer he sent her to, since the amount he collected as his referral fee would be independent of the referee's quality.

In contrast, giving the referring lawyer a contingent share ties the amount of his referral fee to the amount ultimately recovered in the case by the client.[68] It thus gives him an incentive to refer the case to the lawyer who will generate the largest net expected recovery for the client. As a result, we would expect that the optimal referral fee paid by the client -- if any is paid at all -- would consist largely, if not completely,

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[68]An analogous argument has been made why clients who are uncertain about the quality of their case would normally want to pay their lawyer a contingent attorney's fee. Contingent fees encourage the lawyer to pursue the litigation only if there is a reasonable chance of success, while flat (or hourly) fees encourage him to pursue the litigation regardless of the claim's chances of success. See James D. Dana and Kathryn E. Spier, Expertise and Contingent Fees: The Role of Asymmetric Information in Attorney Compensation, __ J. L. Econ. & Org. __ (1994).

of a contingent share for the referring lawyer.

C. Division of the Referral Fee

What should be the relative contributions of the client and the referee lawyer to the referral fee? Suppose the case is referred from *j* to *k*. The client might pay the entire fee; the lawyer might pay the entire fee; or it might be split in some way between them. Which of these options is best, from the standpoint of client welfare?

In general, the optimal referral fee arrangement -- the one that maximzes the client's welfare -- will have *the client and and the lawyer both contribute* to the referral fee. That is: under the optimal referral fee arrangement, the client will collect a smaller fraction of the recovery than he would if no referral fee were paid; and the lawyer will collect also collect a smaller fraction of the recovery than he would if no referral fee were paid.

Let me give a concrete example. Suppose that, if no referral fee were paid, *k* would charge the client a 33 percent contingent fee. (Here we are imagining, counterfactually, that the client hire *k* without being referred to him by *j*.) This means that the client would get 66 percent of the recovery. Now suppose, instead, that a referral fee must be paid.Under

the optimal referral fee arrangement, k should get less than 33 percent of

the recovery, and the client should get less than 66 percent of the

recovery.

As our earlier discussion indicates, this sharing may be achieved in

a variety of ways: the client might pay the whole referral fee and then

recoup part of it by paying an attorney's fee of less than 33 percent; the

lawyer might pay the whole referral fee and then recoup part of it by

collecting an attorney's fee of more than 33 percent. As we saw before,

such arrangements are interchangeable. The important point is that, when

a referral fee must be paid, the client's welfare is maximized by an

arrangement in which *the client's share of the recovery is smaller, and*

the lawyer's share of the recovery is also smaller, than would be true if

no referral fee had been paid.

The intuition behind this result is as follows. In essence, in setting

an attorney's fee, the client faces a delicate tradeoff between two

factors: maximizing the size of the recovery (which favors a large fee)

and maximizing the client's distributive share of the recovery (which

favors a small fee). Giving the lawyer a zero percent fee would obviously

be bad (the lawyer would do no work); giving the lawyer a 100 percent fee

would be bad as well (he would work hard but keep all the proceeds for

himself). Thus, the optimal attorney's fee obviously lies somewhere in between these points; its exact location depends on the details of the lawyer's production function.

An analogous tradeoff must be made in determining how to apportion responsibility for the referral fee. Forcing the lawyer to pay all of it is attractive from a distributive point of view (it maximizes the client's slice of the pie), but is unattractive from the standpoint of encouraging lawyer investment in the case. Forcing the client to pay all of it is attractive from the standpoint of encouraging lawyer investment, but unattractive from a distributive standpoint. In general, the optimal tradeoff between these considerations will have *neither* the lawyer nor the client pay all of it.

Now, the relative burdens that the two should optimally bear depend in part on how good (from the client's standpoint) the underlying attorney's fee arrangement is. If, in general, the "market equilibrium" (as regulated by the state) yields attorney's fees that are too high, then the optimal referral fee arrangement will have the lawyer pay most of the referral fee. The attorney's fee, being too high, gives too small a share of the recovery to the client; forcing the client to bear most of the referral fee would compound this distributive problem.

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In contrast, if the market generally yields attorney's fees are too low, the optimal referral fee arrangement will have the client pay most of the referral fee. The attorney's fee, being too low, gives the lawyer insufficient incentive to invest in the claim; forcing him to pay for the referral would compound this incentive problem. Thus, in this scenario the client would want to pay most of the referral fee, either directly or by adjusting upward the attorney's fee.

Whether the market tends to yield attorney's fees that are too high or too low (in the sense of optimally striking the tradeoff between lawyer incentives and distribution) is an empirical issue. Assessing this requires information about the competitive equilibrium the market is likely to reach; perhaps the fees generated in such a market are too high or too low; perhaps they are approximately optimal. An assessment also requires information about the effectiveness of fee regulation: perhaps there is underregulation, yielding fees that are too high; perhaps there is overregulation; perhaps there is just the right amount of regulation.

Pursuing these complex questions here is unnecessary. The central point for our purposes is that, unless attorney's fees in the market are much too high or much too low, the optimal referral fee arrangement will involve a sharing of the burden by referee and client. For the client to

refuse (or be prohibited from) contributing to the fee probably impairs her welfare; thus, if the referee has paid a referral fee, the client is probably best off permitting a portion of that fee to be passed on to her. At the same time, paying the full referral fee herself probably also impairs her welfare.

VIII. APPLICATIONS AND CONCLUDING REMARKS

Our analysis yields several qualified conclusions about the optimal treatment of lawyer referrals, where the objective is to maximize client welfare. As I stated in the Introduction, one may treat these conclusions as descriptions of what well-informed clients are likely to do; or as prescriptions for regulation, if the regulatory authority believes that clients lack the information to protect their interests effectively.

First, whether paid referrals generally advance client welfare depends on the correlation, in the marketplace, between lawyer profits and net client recoveries. As we have seen, in a system of paid referrals the client is likely to be represented by the lawyer who can earn the largest profit from representing her. If that is also the lawyer who can generate the largest net expected recovery for the client, then the system of paid referrals generally benefits the client. But if there is no

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correlation between lawyer profits and client recoveries, the transaction costs of a system paid referrals may provide sufficient basis for a ban.

Second, where lawyer-paid referrals are permitted, the client is sometimes better off if the lawyers use an up-front payment (rather than giving the referring lawyer a contingent share in the attorney's fee); other times she is better off if lawyers use a contingent share arrangement. Contingent shares do a better job of encouraging a referral to the best lawyer; up-front payments do a better job of encouraging the lawyer who represents the client to invest effort in the claim. It may be in the client's interest to compel the use of one or the other instrument (rather than leaving it up to the lawyers to choose); but which should be compelled depends on which is more important to encourage -- good lawyer selection or hard work by the lawyer. There is, at any rate, no apparent basis for a categorical prohibition on one instrument but not the other.

Third, the optimal referral fee arrangement will generally have the client and the referee lawyer divide between them the cost of the referral fee. Forcing the referee lawyer to pay the full fee -- by preventing her from passing it on to the client -- does not help the client, because it will simply lead the lawyer to invest less effort in the claim (if the referral

fee involves a contingent share). Only if attorney's fees are (in spite of regulation) generally much too high does the client benefit by not contributing to the referral fee. Otherwise, regulations that prevent clients from sharing the burden of the referral fee simply harm their intended beneficiaries.

Each of these conclusions is qualified by an important and as yet unanswered empirical issue. Regarding the desirability of a ban on paid referrals, we need to know something about the correlation between lawyer profits and client recoveries in the marketplace. Regarding regulation of the form of lawyer-paid referral fees, we need to know how important lawyer quality is vis-a-vis lawyer effort in determining the client's net expected recovery. Finally, regarding the sharing of the referral fee burden between lawyer and client, we need to know whether attorney's fees are (as regulated) too high or not. Definitive resolution of the policy questions surrounding lawyer referrals must await resolution of these empirical questions.

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