
Volume 47

Issue 2 Winter 1998: *Symposium - Contingency Fee
Financing of Litigation in America*

Article 8

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Robert H. Mnookin

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Recommended Citation

Robert H. Mnookin, *Negotiation, Settlement and the Contingent Fee*, 47 DePaul L. Rev. 363 (1998)
Available at: <https://via.library.depaul.edu/law-review/vol47/iss2/8>

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NEGOTIATION, SETTLEMENT AND THE CONTINGENT FEE

*Robert H. Mnookin**

By imagining “what would happen” if the contingent fee were abolished by statute, Professor Samuel Gross provides a fascinating perspective on a central feature of the American civil justice system.¹ In this brief Comment I offer four observations each inspired by Professor Gross’s paper.

The first concerns the effects of fee arrangements on the settlement process. In most tort litigation today, “single-shot” plaintiffs with contingent fee lawyers face insured defendants whose lawyers are compensated by the hour. To what extent would the balance of bargaining power between plaintiffs and defendants be shifted in a world without contingent fees where plaintiffs had litigation insurance and where fee shifting with losers paying was the rule?

My second observation, also connected to the settlement process, relates to the potential use of Alternative Dispute Resolution (“ADR”) in accident cases. In a world where the contingent fee was banned, Professor Gross suggests there is little incentive for defendants to participate in ADR.² I explain why, in terms of today’s institutional arrangements, there would in fact appear to be powerful incentives for the demand for ADR to increase in the years to come.

My third observation relates to Professor Gross’s observation that “it is uncommon for plaintiffs’ attorneys to compete by varying the terms of the contingent fee contracts that they offer.”³ If plaintiffs’ lawyers “rarely” compete in this way, in a market where there are admittedly large numbers of lawyers, what alternate form does competition take? With respect to the allocation of cases among plaintiffs’ lawyers, what are the effects?

* Samuel Williston Professor of Law Chair, Steering Committee, The Program on Negotiation at Harvard Law School. An earlier version of this Comment was presented at the Third Annual Clifford Seminar on Tort Law and Social Policy, addressing Contingency Fee Financing of Litigation in America, Chicago, Illinois, April 4-5, 1997.

1. Samuel R. Gross, *We Could Pass a Law . . . What Might Happen if Contingent Legal Fees Were Banned*, 47 DEPAUL L. REV. 321 (1998).

2. *Id.* at 337.

3. *Id.*

My final observation relates to the overall transaction costs of an accident compensation system that largely depends not only on the contingent fee, but also on what Professor Gross correctly characterizes as a "highly complex, privatized, lawyer-dominated system of civil litigation."⁴

I. BARGAINING POWER IN SETTLEMENT

Only a small percentage of lawsuits initiated by contingent fee lawyers are ever tried. Instead, the overwhelming majority of accident cases—certainly over ninety percent—are settled by negotiation, not adjudication.⁵ This does not mean, however, that law and legal institutions are unimportant. To the contrary, I have suggested that parties and their counsel bargain "in the shadow of the law"⁶ where expectations about possible court imposed outcomes, expected transaction costs, and attitudes towards risk all can influence decisionmaking. Because I have long been interested in how law and legal institutions affect out-of-court settlements, I find it interesting to compare the incentives created by today's institutional arrangements with those of an alternative that Professor Gross suggests might arise if the contingent fee were abolished.

As many scholars point out, no single fee arrangement can perfectly align the interests of the lawyer with the interests of the client in all circumstances. This is a central teaching of literature on the "principal-agent" problem.⁷ What is striking about the fee arrangements that

4. *Id.* at 345.

5. Of all automobile insurance claims, the majority settle before any court filing, and most of those suits that are brought to trial settle before any jury verdict. See Marc A. Franklin et al., *Accidents, Money, and the Law: A Study of the Economics of Personal Injury Litigation*, 61 COLUM. L. REV. 1, 10-11 (1961); Marc Galanter, *Reading the Landscape of Disputes: What We Know and Don't Know (and Think We Know) About Our Allegedly Contentious and Litigious Society*, 31 UCLA L. REV. 4, 27 (1983); see generally H. LAURENCE ROSS, *SETTLED OUT OF COURT* (1970) (discussing how the law on a day-to day basis revolves around settlement and not trial); DAVID M. TRUBEK ET AL., *CIVIL LITIGATION RESEARCH PROJECT: FINAL REPORT* (1983) (reporting on a nationwide study of civil cases and discussing the frequency of litigation, costs and lawyers' activities).

Settlement also occurs in some 80% or 90% of criminal matters in almost every American jurisdiction in the form of "plea bargaining." See Albert W. Alschuler, *The Prosecutor's Role in Plea Bargaining*, 36 U. CHI. L. REV. 50, 50 (1968); Galanter, *supra*, at 27.

Similarly, some 75% or more of all administrative proceedings end in agreements rather than trials. GLEN O. ROBINSON & ERNEST GELLHORN, *THE ADMINISTRATIVE PROCESS* 523 (1974); see Peter Woll, *Informal Administrative Adjudication: Summary of Findings*, 7 UCLA L. REV. 436, 437 (1960).

6. Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950, 997 (1979).

7. JOHN W. PRATT & RICHARD J. ZECKHAUSER, *PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 1* (John W. Pratt & Richard J. Zeckhauser eds., 1991).

characterize accident cases today is the relative advantage enjoyed by defendants. In most tort litigation today, a "single-shot" plaintiff is represented by a contingent fee lawyer, while the defendant is typically represented by lawyers retained on an hourly basis by the defendant's insurance company, which is a "repeat player."⁸

Consider the incentive effects operating with respect to settlement, first with respect to the lawyers and next with respect to the parties. With a contingent fee, when the plaintiff's lawyer is considering a settlement offer, that lawyer bears the entire cost of investing additional time in a case, but she receives, as Professor Gross notes in his paper, "only a third of the return" from her work.⁹ A defense lawyer paid on an hourly basis faces an entirely different set of incentives. If discovery is protracted and settlement comes late in the process, defense counsel will be compensated for the additional time invested in the case. I am not suggesting that counsel on either side are typically indifferent to the underlying interests of their clients or that counsel are solely motivated by their own economic interests. Indeed, I believe that both professional norms and concerns about reputation operate to constrain opportunism, at least somewhat. Nonetheless, with respect to settlement negotiations, other things being equal, existing fee arrangements would seem to favor the defense in pre-trial bargaining.

The defense may also have a second advantage in the pre-trial bargaining. With respect to settlement decisions, the plaintiff seeking compensation is typically more risk averse than the insurance company which will be paying any judgment. Bargaining theory suggests that, *ceteris paribus*, the more risk averse party is comparatively disadvantaged.¹⁰ In personal injury cases, the plaintiff is typically an individual who has only one shot at recovery. Rational plaintiffs should therefore be willing to accept less than the expected value of litigation to avoid the risks of trial. Because an insurance company, on the other hand, is a repeat player with a portfolio of cases over which it can spread its risk, the defense can much more credibly claim risk neutrality.

How would these bargaining power imbalances be affected in a world where the contingent fee were replaced by litigation insurance with fee shifting? Professor Gross suggests that in such a world plaintiffs would typically transfer their claims to a company that used its

8. Marc Galanter, *Why the "Haves" Come out Ahead: Speculations on the Limits of Legal Change*, 9 L. & SOC'Y REV. 95, 97 (1974).

9. Gross, *supra* note 1, at 335.

10. Mnookin & Kornhauser, *supra* note 6, at 966, 969-71.

own attorneys to pursue these cases.¹¹ Because the plaintiff would be an institutional, repeat player with many claims, such a plaintiff (like today's insurance company defendants) would tend to be risk neutral. Moreover, in such a world both sides of the dispute would be represented by counsel who were either salaried or paid by the hour. It would therefore seem that the net effect would be settlement negotiations between two risk neutral parties, each represented by counsel who are compensated in a way that creates symmetrical settlement incentives.

II. THE USE OF ADR IN TORTS CASES

My second observation relates to the potential use of Alternative Dispute Resolution ("ADR") in accident cases. Professor Gross suggests that in a world where the contingent fee is banned, little incentive exists for defendants to participate in ADR.¹² My purpose is not to speculate about the use of ADR in a world where the contingent fee is banned, but instead to offer a prediction about the use of ADR—especially mediation—in our world where the use of contingent fee arrangements is likely to continue unabated.

I predict that in the next few years (as in the recent past) mediation will increasingly be used to facilitate the resolution of personal injury cases. Why? My reasoning is straightforward. In accident cases the settlement process is essentially controlled by the plaintiff's lawyer and the defendant's insurance company. To the extent that mediation can be shown to facilitate settlements that require a smaller investment of lawyer time, mediation serves the economic interests of both the plaintiff's contingent fee lawyer *and* the defendant's insurance company.

Other things being equal, a plaintiff's lawyer being paid on a contingency basis would obviously prefer to have a case settled earlier with fewer hours devoted to the litigation process. If I have a one-third contingency, I much prefer an early \$100,000 settlement after twenty-five hours of my effort to a settlement for the same amount on the eve of trial when I would have invested some 150 hours of effort. Plaintiffs' lawyers would surely be big fans of any mediation that can produce this result. On the other hand, a defense attorney being paid by the hour may not share this preference, but the insurance company footing the bill surely does. Insurance companies should therefore press for any process that can produce equivalent results with lower

11. Gross, *supra* note 1, at 330-35.

12. *Id.* at 337.

litigation costs. Thus, to the extent that mediation can deliver its promise of helping litigants earlier in the process develop convergent expectations about what the expected outcome in court would be, I expect demand for such services will increase.

III. CASE SELECTION AND THE CONTINGENT FEE: HOW ARE CASES ALLOCATED?

My third observation concerns competition among lawyers, and the allocation of injury cases among contingent fee lawyers with different levels of ability. Professor Gross observes that "it is uncommon for plaintiffs' attorneys to compete by varying the terms of the contingent fee contracts that they offer."¹³ For one schooled in conventional micro-economics, this observation presents something of a puzzle. In any major metropolitan area there is typically a large number of plaintiffs' lawyers with widely varying levels of skill. In a competitive market—and surely the market for lawyers is competitive—why should an experienced and highly skilled medical malpractice specialist typically offer to represent a plaintiff with a contingent fee contract that is essentially identical to that of a second or third-rate lawyer? On the defense side, some litigators charge \$125 per hour, others charge \$450. More skilled business lawyers typically charge higher hourly fees than less skilled business lawyers.

In identifying this puzzle, my purpose is to highlight one consequence, not to suggest the absence of a competitive market for the services of plaintiffs' lawyers. Competition among plaintiffs' lawyers does not usually take the form of offering to handle a case for a lower percentage; instead, competition takes a different form in which potential plaintiffs compete for the attention of more skilled lawyers. As Herbert Kritzer has pointed out, plaintiffs' lawyers act as "gatekeepers" who screen potential plaintiffs.¹⁴ Those lawyers with reputations for being highly skilled, experienced, and highly successful and consequently whose opportunity costs are much greater, can afford to be much more selective in deciding which cases to accept. If plaintiffs were fully informed in a market where all lawyers are offering the same contingent fee contract, a rational plaintiff would always prefer to sign-on with a more skilled lawyer who (other things being equal) is likely to recover more, by reason of talent and reputation. For example, a potential plaintiff with a medical malpractice claim would obvi-

13. *Id.*

14. Herbert M. Kritzer, *Contingent Fee Lawyers as Gatekeepers in the American Civil Justice System*, 81 JUDICATURE 22 (1997).

ously rather be represented by Robert Clifford than by Robert Mnookin, especially if we are both offering contingent fee contracts in which the lawyer receives one-third of any recovery.

This analysis suggests that the queue of potential plaintiffs is typically longer outside the office of the most talented contingent fee lawyers. As a consequence, I would predict that there is a reasonably high correlation between the talent of a lawyer and the quality of her average case. In other words, through a process that involves both screening and referrals, top contingent fee lawyers end up with portfolios of better cases.

If I am right that the better lawyers end up with stronger cases because they are able to select cases with higher expected recoveries for a given investment of time, then it can be demonstrated that this has a distorting effect with respect to allocation of resources. Economic efficiency would require that the better lawyers get those cases where *at the margin* having a better lawyer will lead to a higher recovery. It can be shown however, that in a market where all lawyers offer the same contingent fee contract, a rational lawyer will be choosing cases on the basis of that lawyer's expected recovery.

A simple example can illustrate my point. Suppose there are two potential medical malpractice cases, one involving Able and the other involving Baker, each of whom has suffered an injury. In Able's case, liability is clear and the amount of damages is both substantial and reasonably certain. As a consequence, the quality of the lawyering does not much affect the expected recovery, provided the lawyer does a competent job of preparing. In the hands of a highly skilled torts lawyer, Able's case is expected to settle for \$3 million, while in the hands of an average lawyer the expected settlement is very nearly the same—say \$2.7 million. Baker's case, on the other hand, is more difficult. The establishment of liability requires a creative but sensible extension of existing legal doctrine and the proof of causality requires marshaling scientific evidence in a sophisticated way. In the hands of a talented specialist, the expected recovery is \$2.4 million, while in the hands of an average lawyer, the expected settlement is far less—only \$300,000.

Note that if the average lawyer and the highly skilled lawyer both offer the same contingent contract, Able and Baker would each obviously prefer to be represented by the highly skilled lawyer. For each plaintiff, the net recovery is higher with the more skilled lawyer. But suppose the highly talented lawyer has time only to take one case and must choose which plaintiff to represent? Which case will she choose, assuming for the moment she expects each to take about the same

amount of time to prepare? The answer is clear: the skilled lawyer with a one-third contingency would prefer Able's case because the expected return to the lawyer is higher. For the same investment of time, the lawyer's expected fee in Able's case is \$1 million, which is obviously more than the \$900,000 fee expected in Baker's case. And yet from the perspective of economic efficiency (i.e., the social point of view) we would prefer that the more talented lawyer devote her time to Baker's case because that lawyer's scarce talent creates much more value and makes more of difference there.¹⁵

What this example shows is that one consequence of a contingent fee system with standardized rates is that lawyers will compete for the "best cases" and that the most talented lawyers will generally end up with portfolios of cases where the expected return is highest. Ironically, the best lawyers probably get many high-stakes, "easy cases" that hardly make the best use of their scarce talent. With hourly fees or with contingent fees that vary substantially from lawyer to lawyer, there would be less of a tendency for this to happen.

IV. TOTAL TRANSACTION COSTS

My closing observation is not offered as a criticism of the contingent fee, but instead relates to the use of a lawyer-driven, individualized, court-based system to transfer money to injured parties. As Professor Gross observes, "[d]evising methods to reduce the overall costs . . . of obtaining compensation for injuries" is an important set of policy objectives to consider in evaluating our present system.¹⁶ I am struck by Professor Gross's observation that "[a]lmost no litigants can afford to play . . . [the present-day civil litigation game] with their own money;"¹⁷ instead, defendants are financed "by liability insurance" and plaintiffs are financed by "contingent fees—which in turn, are financed by liability insurance."¹⁸ As Professor Jeffrey O'Connell has pointed out,¹⁹ and as the RAND studies demonstrate,²⁰ a striking characteristic of the American system of tort-based accident compen-

15. Note that if Baker is rational and well informed, he would gladly pay the more gifted lawyer much more than a third of the additional recovery she might be expected to create. Also Able would prefer to hire the average lawyer on a 10% contingency. A puzzle that is worth exploring both theoretically and empirically is why contingent fee contracts appear to be so standardized.

16. Gross, *supra* note 1, at 323.

17. *Id.* at 345.

18. *Id.*

19. Jeffrey O'Connell, *Early Offers as Contingent Fee Reform*, 47 DEPAUL L. REV. 413, 417 (1998).

20. DEBORAH R. HENSLER ET AL., COMPENSATION FOR ACCIDENTAL INJURIES: RESEARCH DESIGN AND METHODS 2-4 (1991).

sation is that the transaction costs are extraordinarily high. For every dollar transferred to an accident victim for compensation, roughly another dollar is spent on legal fees. If viewed simply as a mechanism for redistribution this system strikes me as nearly impossible to justify. As Professor O'Connell²¹ and Professor Stephen Sugarman²² have each argued, alternative mechanisms exist involving first-party insurance that could transfer money to injured parties at much lower costs. In my view, the fundamental debate, both in academia and state legislatures, should not concern the abolition of the contingent fee, but instead should be focused much more broadly on the advantages and disadvantages of more radical alternatives to a tort system: alternatives that are not dependent for their administration on an individualized, lawyer-dominated system of civil litigation for administration. The critical question is an empirical one: Are the felicitous effects of our present day tort system in deterring negligent conduct and defective products sufficiently substantial to justify a compensation mechanism with high transaction costs?

21. Jeffrey O'Connell, *Harnessing the Liability Lottery: Elective First Party No-Fault Insurance Financed by Third-Party Tort Claims*, 1978 WASH. U. L.Q. 693, 697.

22. See STEPHEN D. SUGARMAN, *DOING AWAY WITH PERSONAL INJURY LAW: NEW COMPENSATION MECHANISMS FOR VICTIMS, CONSUMERS, AND BUSINESS* 76-77 (1989).