

THE LAWYER AS A PORTFOLIO MANAGER: HOW DOES THE FEE SYSTEM INFLUENCE ON THE LAWYER'S DECISION OF HANDLING LEGAL CLAIM?

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Abstract: We use the portfolio theory to analyze the lawyer's decision regarding the type of case the lawyer will handle. We offer some insights into the widespread idea that contingency lawyers are providing a risk sharing service. We demonstrate that a contingent fee lawyer diversifies his portfolio. We show that reputation induces more, but not fully, concentration, since a lawyer with greater reputation or expertise selects more risky cases. The size of the law firm has the same result.

Keywords: Lawyer, legal fee, portfolio analysis.

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INTRODUCTION

Lawyer fee arrangements are subject to a current debate. Contingent fees are widely used in the United States, but are banned or regulated in many other countries (Great Britain, France). In those countries, clients generally paid their lawyer at an hourly fee or a fixed fee. The standard description of the contingent fees is no win, no pay: the lawyer receives a fixed percentage of the amount recovered from the other side if the case is won; he receives nothing if the case is lost. Literature on contingent fees is by no means new and has offered several economics explanations pro and con contingent fees. Several articles have emphasized benefits from allowing the use of contingent fees. Tying the lawyer's fees to the recovery induces the lawyer to exert an efficient level of effort. Contingent fees are a response to a moral hazard problem¹. They may also be a response to asymmetric information between the plaintiff and the lawyer². In other articles, contingent fees are criticized. They are supposed to provide incentives for lawyers to settle cases earlier than clients would wish. Contingent fees are assumed to spur frivolous litigation, since lawyers accept cases with little legal merit³. In summary, the literature concludes that depending on details of the case, either an hourly or a contingent fee system can be the best.

In this article, we do not try to resolve the debate about which explanation of contingent fees is the most accurate. We propose an analysis of the contingency fee lawyer as a portfolio manager. In the portfolio theory, an investor decides whether or not to acquire an asset with uncertain rate of return. Thinking in terms of the portfolio model, lawyers have to evaluate potential cases in terms of the risks involved and the potential returns from the case in order to decide whether or not to drop it. We search for how much time a lawyer will invest in a particular case. Contingency lawyers have to hold a portfolio of cases so as to hedge the risks they are taking on...they are allocating their time based on which cases will produce greater value on margin⁴. In doing so, lawyers control the flow of cases into the legal market.

This paper employs the opportunity cost approach rather than explicitly including the lawyer's cost of effort. Most papers in this literature assume that the lawyer works on

¹ See Murray L Schwartz & Daniel J. B. Mitchell, *An Economic Analysis of the Contingent Fee in Personal Injury Litigation*, 22 STAN. L. REV., 1125-62 (1970); Patricia M. Danzon, *Contingent Fees for Personal Injury Litigation*, 14 BELL J. ECON., 213-24 (1983).

² See James D. Dana & Kathryn Spier, *Expertise and Contingent Fees: The Role of Asymmetric Information in Attorney Compensation*, 9 J. L. ECON. & ORG., 349-67 (1993); Suzanne Scotchmer & Daniel L. Rubinfeld, *Contingent Fees for Attorney: An Economic Analysis*, 24 RAND J. ECON., 343-356 (1990).

³ See Avery Katz, *The Effect of Frivolous Lawsuits on the Settlement of Litigation*, 10 INTER. REV. L. & ECON., 3-27 (1990); Thomas J. Miceli, *Do Contingent Fees Promote Excessive Litigation?*, 23 J. LEG. STUDIES 211-224 (1994).

⁴ Gillian K. Hadfield, *The Price of Law: How the Market for Lawyers Distorts the Justice System*, 98 MICH. L. REV., 953-1006 (2000).

one case and the cost of effort into that case is given by some parameter proportional to the amount of effort devoted into that case. Instead of taking the conventional approach, we take more realistic route by saying that the cost of effort putting into one case comes precisely from being prohibited from working on another case, given the total labor/hour constraint. Using opportunity cost creates a correlation between cases. By selecting a risky case the lawyer rejects the riskless case and vice versa.

The paper is structured as follows. In the next section we set out the basic model based on the idea that lawyers resemble portfolio managers. Section 3 discusses the hourly fee arrangement and considers the law firm's behavior. Section 4 provides a brief conclusion. All proofs are in appendix.

I- A SIMPLE MODEL

Kritzer⁵ discusses three elements of risk facing lawyers: liability risk, quantum risk and effort risk. Liability risk concerns the variation in the likelihood of verdicts favouring plaintiffs. Quantum risk speaks of uncertainty on the amount that will be recovered. Even if there is no uncertainty about whether the plaintiff (and so the lawyer) will win, uncertainty probably remains with regard to damages. Effort risk refers to the uncertainty over the amount of time the case actually looks. According to three studies⁶, Kritzer⁷ exhibits that the probability of success was almost always lowest in medical malpractice. Datas collected by the Civil Litigation Research Project show that the risk that a lawyer receives no fee is higher in federal cases (26% of the cases) than in state cases (17%). Torts and contract cases involve less liability risk (17%) than do cases involving other types of issues (38%). Uncertainty regarding damages is more difficult to assess. Kritzer⁸ proposes to measure quantum risk by computing a ratio of recovery to stakes. Stakes was defined as the lawyer's assessment of what a reasonable settlement would have been. His results exhibit that the risk in tort and contract cases is similar but less than the risk in other cases. So, we can reasonably assume that there exist different types of cases which differ from each other according to the associated risk. There may be routine cases in which the risk is small or null (auto accident cases or security social cases, for example), and there may be risky cases (medical malpractice cases, for example).

We assume a risk-averse lawyer with an initial wealth of 100\$. To capture the risk aversion we shall assume that an award of 10\$ gives to the lawyer a utility of $\log(10) = 2.3$. He has to share his working time, say 1 hour, between two legal claims: a risk-free case and a risky case.

⁵ Herbert Kritzer, *Rhetoric and Reality...Uses and Abuses...Contingencies and Certainties: the American Contingent Fee in Operation, Disputes Processing Research Program*, Working Paper 12-2 (1996).

⁶ See Vidmar, *Medical Malpractice and the American Jury: Confronting Myths about Jury Incompetence, Deep Pockets, and Outrageous Damage awards*, 49-92 (1995); Vidmar, *Are Juries Competent to decide Liability in Tort Cases Involving Scientific/Medical Issues? Some Data from Medical Malpractice*, 43 EMO. L. J., 885-894 (1994).

⁷ See source cited *supra* note 4.

⁸ See source cited *supra* note 4.

A case is characterized by two elements: the probability of prevailing at court and the amount of the recovery. In other words, a case combines liability risk and quantum risk.

We shall consider that the awards of both cases depend on the time devoted by the lawyer. The risk free case award is given by (number of hours) \times 900\$. This award is certain. The risky case award is given by (number of hours) \times R \times 2000\$ with $R > 1$. The parameter R reduces variance and increases expected reward of risky case. It may reflect two ways in which cases interrelate. The first is the impact of reputation⁹. A second way may be the lawyer's own expertise. Let us consider that $R = 2$. We shall consider that the probability of prevailing the risky case is 60%¹⁰.

We shall assume that the market for lawyers is competitive¹¹.

Under a contingent fee arrangement, the lawyer receives a percentage of the recovery and bears 100% of the cost. This corresponds to the dominant form of contingent fee used in United-States. Most datas indicate (Survey of lawyers handling cases in the federal district court conducted by RAND Corporation, survey conducted by the Alaska Judicial Council) that contingency fees are far from uniform. Only about 50-60 percent of fees are one-third. Some datas sets point out fees exceeding one-third and fees less than-third¹².

To simplify, we assume that the lawyer charges the same percentage 30% for both risky and riskless legal claims.

The lawyer will choose the allocation of his working time between risky and riskless legal claims to maximize his expected utility. If he decides to allocate all his working time on the riskless project, his award is (1 hour) \times 30% \times 900\$ = 270\$. His wealth is 270\$ + 100\$ = 370\$, which gives him a utility of 5.91. If he decides to devote all his time to the risky case, his award is (1 hour) \times 30% \times R \times 2000\$ = 1200\$ if he wins. Hence, his wealth if he wins is 1200\$ + 100\$ = 1300\$ and 100\$ if he loses, i.e. his initial wealth. His utility is 6.14. Suppose now that he shares equally his time, his utility becomes 6.22. Therefore, the lawyer is better off when he engages in diversification by handling a mix of cases.

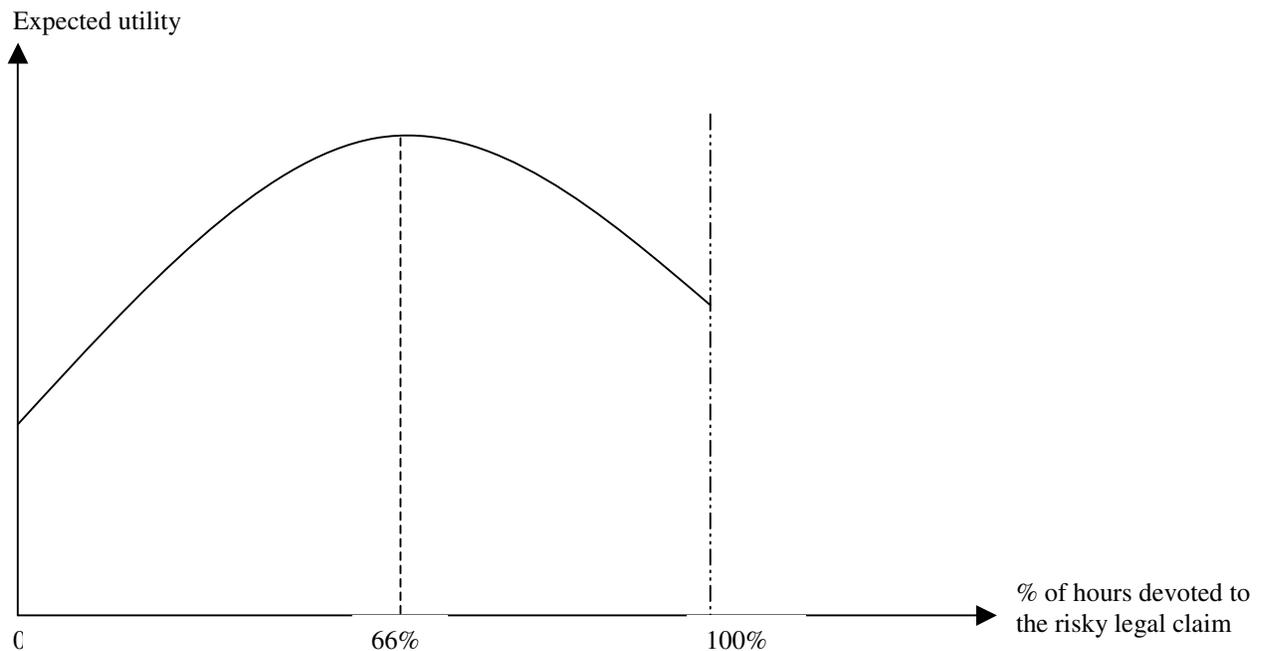
The following graphic shows his expected utility for all time allocation. We see that the optimal time allocation is to devote 66% of the working time to risky legal claims.

⁹ Herbert Kritzer, *Risks, reputations, and rewards: contingency fee legal practice in the United States*, Stanford University Press (2004) (asserting that reputation is important as a form of correlation among investments...correlation arises both from the kinds of cases the lawyer is able to put into the portfolio and from the amount of time the lawyer has to invest in those cases to obtain a return).

¹⁰ It would be more accurate to consider that the probability of prevailing the risky cases depends on the time devoted by the lawyer: more time devoted on the risky case increases the probability that the case will be won. Since the outcome at court is never entirely determined by the actions of the lawyers (the result depends on random events such as the assignment of a judge), this design would allow us to reflect the unpredictability of law. This assumption would not affect qualitatively our conclusions.

¹¹ Many scholars have advanced the view that the market for lawyers and legal services is competitive. *See e.g.*, Charles Silver, *Does Civil Justice Cost Too Much?*, 80 TEX. L. REV. 2088-89 (2002). Nevertheless, this assessment is a much debated question. *See e.g.*, source cited *supra* note 8; Lester Brickman, *The Market for Contingent Fee-Financed Tort Litigation: Is It Price Competitive?*, 25 CAR. L. REV. 65-128 (2003).

¹² Barry Meier, *Lawyer's Foundation Awash in Questions*, NEW YORK TIMES, February 7 (1997).



The lawyer chooses a mix of routine cases which are riskless (low but certain payoffs) and riskier cases which result in high payoffs. This strategy allows him to engage in a kind of hedging: low risk cases cover the overhead but the high risk fees produce the profits. The number of hours devoted to risky legal claim is such that the marginal cost related to the additional risky claim, in other words the loss related to the riskless claim that is not handled, is equal to the marginal benefit from the additional risky claim.

Reputation and the level of contingent fees have important implications for how the lawyer devotes his time. A lawyer with a higher reputation devotes more time on risky case. More reputation increases the award of the risky case, which induces the lawyer to devote more time on this case.

Change in the contingency percentages modifies also the allocation of time. This change may come from change in the market structure or this can be the government or the bar association, which fixes the percentages and decides to change them. The effect of this change is straightforward: an increase in the risky (riskless) contingent fee induces the lawyer to select more risky (riskless) cases.

However, any same change in both contingency percentages involves opposite effects on the allocation of time since it renders both the riskless and risky cases more attractive. The lawyer is both induced to increase his working time on both cases but he cannot because of his time constraint. The award of the riskless case being greater increases his certain wealth, as an increase in his initial wealth. Hence, he becomes less risk averse and he is more interested by risky cases. Moreover, the expected award of the risky case also increases. Finally, he will devote more times on risky cases.

II- DISCUSSION

A- HOURLY FEE

Contingent fees are widely used in the United States, but are banned or regulated in many other countries (Great Britain, France). In those countries, clients generally paid their lawyer at an hourly fee or a fixed fee. We now consider the lawyer's decision regarding how many hours he devotes to risky case under hourly fee arrangement. Under this arrangement, the lawyer is paid for his time regardless of the outcome of the case. The lawyer bears no risk.

It is straightforward that under hourly fee arrangement, the lawyer fully concentrates his portfolio of legal claims on cases that offers the higher fees. Due to the fully concentration, one type of plaintiff is excluded of the legal market.

The advantage of contingent fees is that they ensure that no plaintiff is excluded from the lawyers' market. Indeed, even if characteristics of riskless and risky cases are such that the lawyer fully concentrates his portfolio¹³, then the government or the bar association can differentiate fees for risky and riskless legal claims to ensure that no plaintiff is excluded.

B- LAW FIRM

One characteristic of the legal market is the coexistence of variety of forms and structures of law firms. Clark¹⁴ separates law firms into four categories: solo practitioner including small law firms (up to five lawyers), middle-sized law firms running from six lawyers to fifty, and large firms having over fifty lawyers. The solo or small practitioner must develop a strategy for client development. Concerns of reputation and advertising are options. Large law firms handle diversified problems from domestic relations, real estate and personal injury to problems in international trade, intellectual property or environmental torts. Middle-sized firms often do labor and employment, larger personal injury, as medical malpractice. It seems to exist a specialization of firms according to their size. Nevertheless, inside a category, we may assume the existence of different kinds of legal claims according to the associated risk. All antitrust claim or divorce does not involve the same risk.

Obviously, management of portfolio will be different depending on the size of the law firm. By assuming that larger law firms can achieve more economies of scale or synergies, these two features will increase the initial wealth.

The more realistic approach of the risk aversion considers that richer people are less risk averse than poorer ones. Hence, with a higher initial wealth, a law firm is less risk averse and hence is less reluctant to support risky legal claims. As it might be expected, larger law firms devote more time on risky cases. It follows that larger law firm handle

¹³ *e.g.*, this can be the case when the award of riskless cases are sufficiently high compared to the risky cases' one.

¹⁴ See Gerard J. Clark, *An Introduction to the American Legal Profession in the Year 2000*, 33 SUFFOLK L. REV. 293 (2000).

more risky cases than smaller law firm. This conclusion corresponds to the observations made by Clark¹⁵.

CONCLUSION

The contribution of the paper is to model the idea that the lawyer represents a portfolio of cases. We study the selection of cases for inclusion in the portfolio when cases interrelate in two ways. First, we use an opportunity cost approach, that is time devoted to a case is no more available to another case. Second, we introduce a parameter, which reflects the impact of reputation. In this framework, we show that a contingent fee lawyer diversifies his portfolio by handling a mix of cases. Conversely, an hourly fee lawyer fully concentrates his portfolio by handling only one type of cases. Consequently, one type of plaintiff is locked out the legal market.

Another contribution of the paper is to study the role of reputation. As mentioned above, reputation is important as a form of correlation between cases. Reputation has a second role as a form of incentives constraint. We show that reputation induces more, but not fully, concentration, since a lawyer with greater reputation or expertise selects more risky cases. The size of the law firm has the same effect.

Measures to limit contingent fees are likely to have most impact on the routine cases rather than on the risky cases since under contingent fees, the flow of cases into the legal market is more diversified. No type of claim is left outside the legal market.

¹⁵ *See supra* note 14.