

# CASHING BY THE HOUR: WHY LARGE LAW FIRMS PREFER HOURLY FEES OVER CONTINGENT FEES

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## **Abstract**

Large law firms seem to prefer hourly fees over contingent fees. This paper provides a moral hazard explanation for this pattern of behavior. Contingent legal fees align the interests of the attorney with those of the client, but not necessarily with those of the partnership. We show that the choice of hourly fees is a solution to an agency problem with multiple principals, where the interests of one principal (law firm) collide with the interests of the other principal (client).

Keywords: Law Firms, Legal Fees, Moral Hazard, Risk-Sharing.  
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# CASHING BY THE HOUR: WHY LARGE LAW FIRMS PREFER HOURLY FEES OVER CONTINGENT FEES

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# 1 Introduction

The economic literature on large law firms has been mostly focused on the internal organization of the firm, namely the efficiency of partnership arrangements<sup>1</sup> and their impact on the market for lawyers.<sup>2</sup> This literature is motivated by two empirical observations: lawyers working for large law firms earn high wages and labor contracts can be loosely described as operating under “up-or-out” rules.

In our paper, our main concern is to explain a third empirical observation: large law firms use hourly fees rather than contingent legal fees. There is a vast literature on the efficiency of contingent legal fees<sup>3</sup>, but not much discussion on why large law firms prefer to practice hourly fees in general. In fact, we can say that most of the economic literature emphasizes the advantages of practicing contingent legal fees and the inefficiencies of using hourly fees. In part, this trend can be explained by the fact contingent fees are by large the most common practice in litigation in the United States.<sup>4</sup>

In her work, Hadfield (2000) characterizes the market for lawyers by considering two segments: the corporate and the personal client. The personal client sphere is characterized by either solo practitioners or small law firms (usually general practice firms, or at most slightly specialized). Most of the work is routine (what she calls noncontested legal work) and some litigation (usually under a regime of contingent legal fees). Lawyers in this segment are less well established and influential in the profession, earn lower incomes and their work is seen as lower prestige.

The corporate segment is characterized by large law firms. They hire

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<sup>1</sup>Gilson and Mnookin, 1985, 1989, 1994; Carr and Mathewson, 1990; O’Flaherty and Siow, 1995; Ferrall, 1996; Wang, 2000; Rebitzer and Taylor, 2001.

<sup>2</sup>Spurr, 1987; Rosen, 1991; Rebitzer and Taylor, 1995; Sauer, 1998.

<sup>3</sup>Schwartz and Mitchell, 1970; Danzon, 1983; Halpern and Turnbull, 1983; Lynk, 1990; Miceli and Segerson, 1991; Thomason, 1991; Dana and Spier, 1993; Gravelle and Waterson, 1993; Miceli, 1994; Hay, 1996, 1997; Rickman, 1999; Emons, 2000; Santore and Viard, 2001; Polinsky and Rubinfeld, 2002a, 2002b.

<sup>4</sup>Contingent fees for the plaintiff’s attorney are the most pervasive form of payment in personal injury and medical malpractice litigation. In one major study, 96 % of individuals who were plaintiffs in tort litigation paid their attorneys on a contingent-fee basis.

graduates from the best law schools, usually well-connected and quite influential in the profession. The work of these lawyers includes serving business clients and engaging in complex transactions and litigation (under a regime of high hourly fees that generates high annual incomes). This work is perceived as high prestige.

We propose four explanations, three of them directly related to the literature on contingent legal fees and the last one fully developed in a model. The first explanation is that contingent legal fees are a device to solve a liquidity constraint on the plaintiff's side (Dana and Spier, 1993). Plaintiffs may not have enough assets to hire an attorney under a regime of hourly fees. Large law firms are specialized on the corporate segment of the market for legal services. As a consequence, the problem of a liquidity constraint is not as relevant here as in the personal client segment.

The second explanation is driven by the thesis that contingent legal fees aim at achieving efficient risk-sharing (Dana and Spier, 1993). In the context of personal client segment, the partnership is presumably less risk averse than the client (due to the fact that it is easier to diversify assets for a group of individuals -partners- than for one individual). Thus, contingent legal fees would ensure more efficient risk sharing than hourly fees because they shift some of the risk from the client (more risk averse) to the partnership (less risk averse). However, in the corporate segment, the client is a corporation. In economics, a corporation is the most common example of risk neutrality (due to the fact that shareholders can diversify their portfolio by buying and selling shares at the stock exchange whereas partners have a binding constraint, namely they cannot "sell" shares of the partnership). Thus, hourly fees ensure efficient risk sharing because they do not shift risk from the client (less risk averse) to the partnership (more risk averse).

A third explanation is related to the use of contingent legal fees in class-action litigation (Lynk, 1990). Due to the fact that large law firms tend to specialize on the corporate segment and corporations hardly engage as plaintiffs in class-action, contingent legal fees will be less frequent.

These three previous explanations rely on relating the economic literature on contingent legal fees with some of the observations concerning large law firms by Hadfield (2000). Nevertheless, our paper presents a fourth

explanation based on a moral hazard problem. Moral hazard and adverse selection (including signaling and screening) explanations of contingent legal fees (Schwartz and Mitchell, 1970; Danzon, 1983; Halpern and Turnbull, 1983; Dana and Spier, 1993; Gravelle and Waterson, 1993; Rubinfeld and Scotchmer, 1993; Hay, 1996; Emons, 2000; Polinsky and Rubinfeld, 2002a) have stressed that the need to align the interests of the lawyer (the agent) with those of the client (the principal). In our model, the lawyer is an agent of the client and of the partnership. Contingent legal fees align the interests of the lawyer with those of the client, but not necessarily with those of the partnership.

In our model, we have a problem of moral hazard with multiple principals with conflictive interests. We do not focus our explanation on adverse selection. Landers, Rebitzer and Taylor (1996) show that large law firms have an adverse selection problem in the determination of work hours. The promotion to partner of the associate who have a higher propensity to work hard and relying on the number of work hours as good measure of performance leads to an equilibrium in which associates work too many hours. In order to concentrate on the choice of legal fees rather than the determination of work hours, we will consider the case where the lawyer is already a partner and has passed the tournament stage.

In section two, we develop the model and present the conditions under which the partnership prefers a contingent legal fees regime to hourly fees arrangement. In section three, we provide further analysis by relaxing some assumptions, and section four concludes the paper with final remarks.

## 2 Model

There are three players, all assumed to be risk neutral: Attorney (A), Plaintiff (P) and Law Firm (L). The plaintiff has been a victim of an accident or contract breach, and wants to sue an injurer (the defendant) and be paid compensatory or expectation damages  $J$  which is common knowledge. The probability of winning is  $p$  and depends on the effort exerted by the attorney.

The attorney works  $h$  hours on the case. These work hours can be of

low quality  $h_1$  or of high quality  $h_2$ . A high quality hour increases more the probability of winning than a low quality hour. Thus, we assume  $p_1 > 0$ ,  $p_2 > 0$ ,  $p_{11} < 0$ ,  $p_{22} < 0$ ,  $p_{12} < 0$ , and  $p_2 > p_1$  for  $h_1 = h_2$ , where subscript 1 refers to low quality hours and subscript 2 refers to high quality hours.

The opportunity cost of the attorney is given by  $\theta_1 h_1 + \theta_2 h_2$ , where  $\theta_1 < \theta_2$ . High quality hours are more costly than low quality hours for the attorney.

The attorney is assumed to be a partner of the law firm.<sup>5</sup> The partnership has an opportunity cost given by  $\eta_1 h_1 + \eta_2 h_2$ , where  $\eta_1 < \eta_2$ . The opportunity cost of the partnership refers to the use of resources available to all attorneys working for the firm, e.g. junior staff, paralegals, secretaries, research assistants, computers, office material, etc.

Let us define  $S$  as the amount of money the plaintiff pays. The payoffs for the plaintiff, partner and partnership are respectively:

$$V^p = p(h_1, h_2)J - S$$

$$V^a = S - \theta_1 h_1 - \theta_2 h_2$$

$$\begin{aligned} V^l &= V^a - \eta_1 h_1 - \eta_2 h_2 \\ &= S - (\theta_1 + \eta_1)h_1 - (\theta_2 + \eta_2)h_2 \end{aligned}$$

The timing of the game is:

- (1) L decides on the policy of the partnership concerning fees.
- (2) P hires A. A contract specifies  $S$ ,  $h_1$ , and  $h_2$  if contractible.
- (3) A decides  $h_1$  and  $h_2$  (either confirms or defects from the contract with P).
- (4) The case is either won or lost, P pays A.

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<sup>5</sup>By assuming that the tournament for partnership is not an issue, we do not engage in the discussion about the choice of performance measures (i.e., number of cases won and the number of work hours) and the distortions on incentives that may arise as a consequence. See Landers, Rebitzer and Taylor (1996).

## 2.1 Efficient Contract

The efficient contract is determined by maximizing the joint surplus of all players:

$$p_j = (\theta_j + \eta_j)/J \quad j = 1, 2 \quad (1)$$

Assuming that the market for lawyers is competitive (so that the participation constraint is binding for the attorney<sup>6</sup>) and the attorney's reservation utility is zero:

$$S = \theta_1 h_1^* + \theta_2 h_2^* \quad (2)$$

## 2.2 Contract with Moral Hazard

Suppose the number of low and high quality hours to work is not observable and contractible. The plaintiff and the law firm can only observe and contract on the total number of hours  $h$  and on the outcome of the case (win or lose). Thus, the efficient contract is not sustainable due to the opportunism of the attorney.

### 2.2.1 Hourly Fees

Let us assume hourly fees (hereafter, HF). The plaintiff pays  $w$  per hour and chooses the number of hours to be assigned to the case. The payoffs are:

$$V^p = p(h_1, h_2)J - w(h_1 + h_2)$$

$$V^a = w(h_1 + h_2) - \theta_1 h_1 - \theta_2 h_2$$

$$V^l = w(h_1 + h_2) - (\theta_1 + \eta_1)h_1 - (\theta_2 + \eta_2)h_2$$

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<sup>6</sup>We will relax this assumption later and see how much our results change. As Hadfield (2000) argues, one of the problems with the market for lawyers is that it is very much noncompetitive.

The attorney chooses zero high quality hours (since they are more expensive and generate the same gain as low quality) and the number of low quality hours equals the amount of hours chosen by the plaintiff, say  $h$ . Thus, payoffs are:

$$V^p = p(h, 0)J - wh$$

$$V^a = (w - \theta_1)h$$

$$V^l = (w - \theta_1 - \eta_1)h$$

The attorney will only accept the case if the hourly fee  $w$  is at least  $\theta_1$ . The payoff for the plaintiff is:

$$V^p = p(h, 0)J - \theta_1 h$$

The number of hours chosen by the plaintiff is  $\hat{h}$  such that  $p_1 J = \theta_1$ . It is clear that  $\hat{h} > h_1^*$  because (a) the marginal cost for the partnership is ignored and (b) there are zero high quality hours. In summary, under a regime of hourly fees,  $\hat{h}_1 = \hat{h} > h_1^*$  and  $\hat{h}_2 = 0 < h_2^*$ .

### 2.2.2 Contingent Fees

Let us consider contingent fees (hereafter, CF) now. The plaintiff pays a fraction  $\alpha$  of compensatory damages  $J$  if the case is won. The attorney chooses low and high quality hours assigned to the case since they are not contractible.

$$V^p = (1 - \alpha)p(h_1, h_2)J$$

$$V^a = \alpha p(h_1, h_2)J - \theta_1 h_1 - \theta_2 h_2$$

$$V^l = \alpha p(h_1, h_2)J - (\theta_1 + \eta_1)h_1 - (\theta_2 + \eta_2)h_2$$



The attorney chooses low and high quality hours such that:

$$\alpha p_j = \theta_j / J \quad j = 1, 2 \quad (3)$$

Given the binding participation constraint for the attorney, the contingent fee  $\alpha$  has a lower bound, say  $\bar{\alpha}(\theta_1, \theta_2, J)$ . The plaintiff chooses  $\alpha$  to maximize  $V^p$  subject to  $\alpha \geq \bar{\alpha}$ . The lower bound is more likely to be binding when the marginal costs are higher or when compensatory damages are low.

The contingent fee that maximizes the payoff of the plaintiff is:

$$\begin{aligned} V_\alpha^p &= -pJ + p_1 J h_{1\alpha} + p_2 J h_{2\alpha} \\ &= -pJ + \theta_1 / \alpha h_{1\alpha} + \theta_2 / \alpha h_{2\alpha} = 0 \end{aligned}$$

Thus, we can re-write the first-order condition as:

$$\alpha = (\theta_1 h_{1\alpha} + \theta_2 h_{2\alpha}) / (pJ) \quad (4)$$

Thus, the optimal choice by the plaintiff is given by (4) if  $\alpha \geq \bar{\alpha}$ , and is  $\bar{\alpha}$  otherwise. It is easily shown that  $h_1^{CF} < \hat{h}_1$  and  $h_2^{CF} > \hat{h}_2 = 0$ .

### 2.3 The Law Firm Chooses HF or CF

Given the choices of the plaintiff and of the attorney, the law firm announces the policy of the partnership concerning fees. Hourly fees are preferred to contingent fees if the following condition is satisfied:

$$-\eta_1 \hat{h} > \alpha p(h_1^{CF}, h_2^{CF})J - (\theta_1 + \eta_1)h_1^{CF} - (\theta_2 + \eta_2)h_2^{CF} \quad (5)$$

Let us start by considering the situation where the participation constraint is binding in both case, hourly fees and contingent fees. The condition for choosing hourly fees can be simplified and becomes:

$$\eta_1 \hat{h} < \eta_1 h_1^{CF}(\alpha) + \eta_2 h_2^{CF}(\alpha)$$

If  $h_1^{CF} + h_2^{CF} \geq \hat{h}$ , then the law firm will always prefer hourly fees. If contingent legal fees imply too many work hours from the viewpoint of the

partnership, a regime of hourly fees will be chosen. The only situation where contingent fees would be preferred is if by using them there is a sufficiently big reduction in low quality hours that more than compensates for the extra cost of high quality hours.

It is also intuitive that hourly fees will be more likely to be preferred if  $\eta_2/\eta_1$  is significantly greater than  $\theta_2/\theta_1$ , i.e., if high quality hours are relatively more expensive than low quality hours for the partnership than for the attorney.

Suppose now that the participation constraint is not binding in the case of contingent fees (it is necessarily binding in the case of hourly fees due to the assumption of a competitive market for lawyers). We are back to (5). Under these circumstances, the results are not so straightforward and in fact it is less likely that the law firm will prefer hourly fees. The rationale is of course that contingent fees generate more revenues. Thus, hourly fees will be preferred if and only if the cost is much lower than under contingent fees.

## 2.4 What Happens if the Market for Lawyers is not Competitive?

If the market for lawyers is not competitive, it could be that the participation constraint is not binding for the attorney. We may consider the case where attorneys are scarce and plaintiffs compete for lawyers. In other words, the participation constraint is binding for the plaintiff and not for the lawyer.

In the case of hourly fees, the choice of hours by the plaintiff is  $p_1 J = w$  and the hourly fee is such that  $w = p(\hat{h}, 0)J/\hat{h}$ . It is easy to see that in this case  $w > \theta_1$  (because the participation constraint is not binding for the attorney) and so the choice of  $\hat{h}$  is lower than previously.

In the case of contingent fees, the plaintiff will offer  $\alpha = 1$  because of competition for lawyers. As a consequence, the choice of hours by the attorney satisfies  $p_j J = \theta_j$  for both  $j = 1, 2$ . In comparison to previous results, there will be more low and high quality hours,  $h_1^{CF}$  and  $h_2^{CF}$ .

Given the choices of the plaintiff and of the attorney, the law firm an-

nounces the policy of the partnership concerning fees. Hourly fees are preferred to contingent fees if the following condition is satisfied:

When the market for lawyers is not competitive, the results are not as neat as before. On one hand, contingent fees generate higher expected compensatory damages to be collected (the moral hazard problem is mitigated). At the same time, marginal costs are higher under contingent fees. In fact, we can calculate a critical level  $\bar{J}$  above which contingent fees will be preferred, where:

$$\bar{J} = [(\theta_1 + \eta_1)(h_1^{CF} - \hat{h}) + (\theta_2 + \eta_2)h_2^{CF}] / (p(h_1^{CF}, h_2^{CF}) - p(\hat{h}, 0))$$

It is quite intuitive to observe that  $\bar{J}$  will be higher (it is less likely that contingent fees will be preferred) if  $\eta_2$  (cost of high quality hours for the partnership) is higher relatively to  $\eta_1$  (cost of low quality hours for the partnership).

## 2.5 The Plaintiff Prefers HF or CF?

If the participation constraint is binding for the plaintiff, she gets her reservation utility (normalized to zero) in both regimes. Hence, she is indifferent. However, if the participation constraint is binding for the attorney (and not for the plaintiff), hourly fees are preferred to contingent fees if the following condition is satisfied:

$$p(\hat{h}, 0)J - \theta_1\hat{h} \geq (1 - \alpha)p(h_1^{CF}, h_2^{CF})J$$

If the plaintiff could sell the case to the lawyer, contingent fees would always be preferred since both are risk neutral and the agent (the lawyer) would become the residual claimant. However, because the lawyer cannot buy the case (a consequence of the champerty doctrine), contingent fees do not solve completely the moral hazard problem.<sup>7</sup>

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<sup>7</sup>A similar results would apply if plaintiff and attorney use the modified contingent fee system proposed by Polinsky and Rubinfeld (2002a, 2002b).

The preference of the plaintiff over the regime of legal fees will depend on two effects: (a) how much the use of contingent legal fees increases the probability of prevailing and collecting  $J$  (i.e., how much the moral hazard problem is in fact mitigated by contingent fees) and (b) how much more expensive is the use of contingent legal fees for the plaintiff (i.e., how large the attorney's share of the damages to be collected is). We can calculate a critical level for  $\alpha$ , say  $\underline{\alpha}$ , above which hourly fees are preferred, where

$$\underline{\alpha} = \frac{[p(h_1^{CF}, h_2^{CF}) - p(\hat{h}, 0)]J + \theta_1 \hat{h}}{p(h_1^{CF}, h_2^{CF})J}$$

If  $\alpha$  is greater than  $\underline{\alpha}$ , mitigating the moral hazard problem is too costly for the plaintiff and she prefers hourly fees.

### 3 Further Analysis

In the previous version of the model, we have assumed that the partnership has a policy of allocating to each partner the gains from the case they take. However, in some large law firms, partners get a fraction of these gains, a fraction that usually corresponds to the share each partner has in the partnership. Let us assume that each partner has a fraction  $\lambda$  of the partnership. The payoff for the partner is given by:

$$V^a = \lambda(S - \eta_1 h_1 - \eta_2 h_2) - \theta_1 h_1 - \theta_2 h_2$$

The payoffs for the plaintiff and for the partnership are the same as before.

#### 3.1 Contract with Moral Hazard

The efficient contract is the same since the joint surplus is the same. Different rules of allocation of profits are just redistribution of the efficient surplus.

### 3.1.1 Hourly Fees

The attorney chooses zero high quality hours and the number of low quality hours equals the amount of hours chosen by the plaintiff,  $h$ . Thus, payoffs are:

$$V^p = p(h, 0)J - wh$$

$$V^a = [\lambda(w - \eta_1) - \theta_1]h$$

$$V^l = (w - \theta_1 - \eta_1)h$$

The attorney will only accept the case if the hourly fee  $w$  is at least  $\eta_1 + \theta_1/\lambda$ . The payoff for the plaintiff is:

$$V^p = p(h, 0)J - (\eta_1 + \theta_1/\lambda)h$$

The number of hours chosen by the plaintiff is  $\hat{h}$  such that  $p_1 J = (\eta_1 + \theta_1/\lambda)$ , where  $\hat{h}$  is increasing in  $\lambda$ .

When  $\lambda = 1$ , the choice of hours  $\hat{h} > h_1^*$  because, even though the plaintiff's marginal cost equals the social marginal cost, the number of high quality hours is zero (low and high quality hours are imperfect substitutes). However, when  $\lambda < 1$ , the plaintiff's marginal cost is superior to the social marginal cost. Thus, unlike in the previous section, it is not clear that  $\hat{h} > h_1^*$  (i.e., the number of hours chosen by the plaintiff is more than the number of efficient low quality hours). The reason for that is the marginal cost for the plaintiff being higher than that for partnership (because the attorney does not get the full product of her work, but only a fraction  $\lambda$ ).

In summary, under a regime of hourly fees,  $\hat{h}_1 = \hat{h} \neq h_1^*$  and  $\hat{h}_2 = 0 < h_2^*$ .

### 3.1.2 Contingent Fees

Let us consider contingent fees. Expected payoffs are:

$$V^p = (1 - \alpha)p(h_1, h_2)J$$

$$V^a = \lambda[\alpha p(h_1, h_2)J - \eta_1 h_1 - \eta_2 h_2] - \theta_1 h_1 - \theta_2 h_2$$

$$V^l = \alpha p(h_1, h_2)J - (\theta_1 + \eta_1)h_1 - (\theta_2 + \eta_2)h_2$$

The attorney chooses low and high quality hours such that:

$$\lambda \alpha p_j = \theta_j / J + \lambda \eta_j / J \quad j = 1, 2 \quad (6)$$

From (6), as  $\lambda$  (attorney's share of the partnership) increases, both  $h_1^{CF}$  and  $h_2^{CF}$  increase due to the fact that the marginal expected revenue from the lawsuit increases.

Given the binding participation constraint for the attorney, the contingent fee  $\alpha$  has a lower bound. Abusing of notation, let us say the lower bound is  $\bar{\alpha}(\theta_1, \theta_2, \eta_1, \eta_2, J, \lambda)$ . As before, the plaintiff chooses  $\alpha$  to maximize  $V^p$  subject to  $\alpha \geq \bar{\alpha}$ . Notice that the lower bound is more likely to be binding when  $\lambda$  is lower due to the fact that the attorney as a lower percentage of the expected revenues generated by the lawsuit (and thus requires higher legal fees).

The contingent fee that maximizes the payoff of the plaintiff is:

$$\begin{aligned} V_\alpha^p &= -pJ + p_1 J h_{1\alpha} + p_2 J h_{2\alpha} \\ &= -pJ + \sum_{j=1}^2 \left[ \frac{\theta_j}{\alpha \lambda} + \frac{\eta_j}{\alpha} \right] h_{j\alpha} = 0 \end{aligned}$$

Thus, we can re-write the first-order condition as:

$$\alpha = \sum_{j=1}^2 \left[ \frac{\theta_j}{\lambda} + \eta_j \right] h_{j\alpha} / (pJ) \quad (7)$$

The optimal choice by the plaintiff is given by (7) if  $\alpha \geq \bar{\alpha}$ , and is  $\bar{\alpha}$  otherwise. As before, it is easily shown that  $h_1^{CF} < \hat{h}_1$  and  $h_2^{CF} > \hat{h}_2 = 0$ .

### 3.2 The Law Firm Chooses HF or CF

As before, hourly fees are preferred to contingent fees if (5) is satisfied. We have just seen that there is a negative relationship between  $\alpha$  and  $\lambda$  under a regime of contingent fees. In order to have the adequate incentive, an attorney with a small share of the partnership needs a larger legal fee. Thus, in terms of the partnership, the expected revenues are higher. Hence, it is less likely that hourly fees will be preferred.

Our model predicts that law firms that allocate revenues to each partner according to the gains of the cases they take rather than according to their share of the partnership are more likely to practice hourly fees. Whereas in the first case, the attorney ignores the opportunity costs of using common resources, in the second case, these costs are somehow internalized.

## 4 Final Remarks

In this paper we have presented an explanations for why large law firms prefer hourly fees rather than contingent legal fees. Under a regime of contingent legal fees, attorneys may work too much and invest too many resources into the case from the viewpoint of the law firm. The opportunity cost of using common resources (e.g., paralegals, secretaries, office materials) is not fully taken into account by attorneys thus leading to too much being spent from the viewpoint of the partnership. As a consequence, hourly fees may provide a solution to this problem.

Our model also predicts that law firms that allocate revenues to each partner according to the gains of the cases they take rather than according to their share of the partnership are more likely to practice hourly fees. The rationale is that attorneys that are paid according to their share of the partnership internalize better (even though not fully) the opportunity cost of using common resources.

Given the preference of large law firms for hourly fees, one could investigate how that affects the likelihood of a settlement. However, there is a

controversy concerning the effect of contingent legal fees on settlement rates (Thomason, 1991; Miceli, 1994; Hay, 1997; Rickman, 1999; Polinsky and Rubinfeld, 2002b). As a consequence, we cannot say that given the choice of legal fees regime, there is a higher or a lower likelihood of a settlement in personal litigation than in corporate litigation.

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