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Article

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Who Benefits from the Uniformity of Contingent Fee Rates?

Abstract: Lawyers' contingent fee (CF) rates are rather uniform, often one-third of the recovery. Arguably, this uniformity is a type of anti-competitive price-fixing, which results in clients paying supra-competitive fees. This paper challenges this argument. It shows that uniform CF rates provide clients with an important advantage, as such rates enable them to make a de facto "take-it-or-leave-it" offer. Consequently, lawyers cannot exploit their private information, and clients retain the transaction's entire surplus and may hire the best lawyer among those who find it profitable to handle the case.

The paper also addresses the effect of uniformity of CF rates when lawyers refer cases to other lawyers. It shows that uniformity facilitates matching of clients and lawyers through the referral system. It also demonstrates that the fact that both direct clients and those obtained through paid-for referrals pay the same CF rate does not attest to cross-subsidization. The clients whose cases are transferred for a referral fee (paid by the handling lawyer) "pay" for the referral service by obtaining a less highly ranked lawyer.

Keywords: contingent fee, lawyers, uniform prices

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1 Introduction

Contingent fee (CF) arrangements are the standard method of financing civil litigation in several types of suits, including those related to personal injury and the collection of commercial and retail accounts. Under such arrangements, the attorney's fee is contingent on the success of the claim, calculated as a certain

percentage of the amount recovered, and paid upon recovery. This practice offers substantial advantages to plaintiffs. Since plaintiffs pay the fee only upon recovery, CF arrangements provide them with credit (Schwartz and Mitchell, 1970:1125-1126), thus considerably enhancing their access to the civil justice system. These arrangements are particularly attractive to loss-averse plaintiffs; unlike an hourly or a global fee, a CF does not expose them to the risk of loss if the claim fails (Zamir and Ritov, 2010). It is also likely to yield superior incentives for the lawyer, compared to hourly and global fees, both in deciding whether to pursue the case (Dana and Spier, 1993) and in handling it (see, e.g. Rickman, 1994; Polinsky and Rubinfeld, 2003).

CF arrangements are nevertheless highly controversial. A central criticism of the CF practice focuses on the fact that CF rates in the United States are distinctively, albeit not invariably, uniform. The conventional flat CF rate in the United States is one-third of the recovery. According to Kritzer (2002), about two-thirds of the cases (excluding those governed by special regulation) involve a fixed percentage (flat fee); in 88% of these cases, the CF is 33% of the recovery. In cases employing a variable percentage rather than a flat fee, the attorney will commonly charge 25% of the recovery if the case does not go to trial or does not involve substantial trial preparations; 33% if the case goes beyond this point and ends at a trial-court decision; and 40–50% if the case results in an appeal (see also Brickman, 2003a; Kritzer, 2004; Engstrom, 2011; Schwartz, 2012:360).

Arguably, this uniformity attests to collusion in the market, which often results in clients paying supra-competitive fees (Schwartz and Mitchell, 1970; Brickman, 1989, 2003b; Drummonds, 1993:891, n.123; Painter, 1995; Hadfield, 2000; Fisch, 2002:670-671; Swett, 2010:656-659). In a competitive market, one would presumably expect CF rates to vary, as cases differ in terms of the costs of providing the legal services (particularly the expected amount of work and the attorney's opportunity costs) and the expected value of the fee, determined by the size of the claim and the prospects of winning it. It would seem that in a competitive market plaintiff lawyers would not charge the same CF rate in small and large cases and that top lawyers would charge higher rates than less-qualified ones.

Additional evidence of the supra-competitive fees in the CF market, so it is argued, is that lawyers who receive referrals from other lawyers, and pay referral fees as high as one-third or one-half of the fee paid by the plaintiff (Spurr, 1988:100-102), charge the same CF rate in these cases as they charge when they do not bear this extra cost. If clients always pay the same CF rate, then the handling lawyer's net fee in those cases which she obtains directly is much higher than in cases referred to her by another lawyer (Brickman 1989:109, 2003b:88-89; Engstrom, 2011:865, n. 286).

It is claimed that the CF market is not competitive due to clients' acute information problems (regarding the expected recovery, the risk involved in the suit, the quality of legal services provided, and the time required to handle the case), clients' prohibitive search costs, and various means devised by lawyers to inhibit competition (Brickman 1994, 2003b; Painter, 1995; Gross, 2006). These means include uniform pricing practices, the absence of price advertisements, and prohibitions against the purchase of tort claims and against brokerage of lawyers' services (Brickman, 2003b).

According to this common depiction, the uniformity of CF is harmful to clients' interests. We challenge this claim. We offer more innocuous explanations for the uniformity of CF rates and argue that this uniformity is not necessarily detrimental to clients. In fact, given their information problem, this uniformity provides clients with significant advantages.

Uniform CF rates do not yield uniform expected fees, but differential ones, depending on the scope of work and the expected recovery in each case. As long as there is a "positive assortative matching" of cases and attorneys, such that the best attorneys handle the most lucrative cases, the second-best attorneys handle the second-most lucrative cases, and so forth, uniform CF rates will yield effective fees that are correlated to the quality of legal services provided. The uniformity of CF rates is thus pseudo-uniformity (Mnookin 1998:67-68).

As uniform CF rates yield varying effective fees, it is unlikely that this uniformity is a product of market collusion. More importantly, and counter-intuitively, we suggest that the uniformity of CF rates provides clients with an important advantage. Since clients choose which lawyer to hire, the uniformity of CF rates is tantamount to clients making a de facto "take-it-or-leave-it" offer. The non-negotiability of the CF rate precludes lawyers from exploiting their private information about the expected value of the lawsuit and the amount of work it might entail. Clients with a good sense of the ranking of lawyers are able to hire the best lawyer among the ones who are willing to handle the case. The uniformity also enables the clients to retain the transaction's entire surplus.

When clients lack information about lawyers' ranking, matching is advanced through the referral system. The uniformity of CF rates oils the wheels of this referral system, especially when referral fees are also uniform. Finally, we show that charging the same CF rate for cases which a lawyer gets directly as for those she receives through paid-for referrals does not yield economic rents for the lawyer, since the best-available lawyer hired through the referral system is not as highly ranked as a lawyer hired directly. Consequently, each lawyer earns a similar net fee in the two types of cases she handles, and the client whose case was referred for a fee "pays" for this service by receiving poorer representation than she would have received had she found the most suitable lawyer herself.

We do not argue that uniform CF rates are necessarily superior to non-uniform CF rates, as some clients might have been better off with negotiable CF rates. However, given the prevalent information asymmetry in the CF market, this uniformity provides clients with significant advantages as compared to other conceivable market schemes. While the combination of uniform CF rates and the referral system has its pitfalls, it may well be the case that it better serves the interests of clients and enhances aggregate social welfare as compared to alternative schemes, such as explicit brokerage in legal services without a uniform CF rate. Given the clients' information problem, a market with negotiable CF rates may adversely affect both the interests of the clients and social welfare.

Some clarifications regarding the scope and objectives of this study are in order. Different fee arrangements, such as a global fee, an hourly fee, and a CF, have different incentive effects (e.g. Polinsky and Rubinfeld, 2003; Emons, 2006; Hyde, 2006; Friehe and Baumann, 2012). These incentives are important because attorneys' efforts are largely unobservable and unverifiable. We will not discuss these incentive effects in any detail, but rather take the choice of a CF arrangement as given. In the same vein, we will not delve into the question of why CF arrangements are particularly popular among personal-injury plaintiffs, while remaining quite rare among defendants and in other spheres of legal representation (on the former puzzle, see Dana and Spier, 1993; Zamir and Ritov, 2010:275-281). Our analysis will, however, shed new light on these important issues as well. Inasmuch as uniform CF rates assist clients who face serious information problems, it is unsurprising that clients who do not face such problems are much less inclined to use this fee arrangement.

Our analysis is potentially germane to other markets in which uniform CF arrangements are prevalent, such as real-estate brokerage, underwriting, and royalties. The analysis is also relevant to other markets where customers' information problems are (or can be) mitigated by keeping some variables constant across all or most products. Limiting the dimensions of the transaction that customers need to consider and compare when making their choices likely ameliorates their decisions and enhances overall efficiency.

The article is structured as follows. Section 2 briefly surveys some of the related literature. Section 3 presents a model that illustrates how uniform CF rates benefit clients and may facilitate matching of cases and attorneys when clients know the ranking of prospective lawyers. Section 4 discusses the model's results based on empirical findings, and addresses its limitations. Section 5 relaxes the assumption regarding clients' information about lawyers ranking and explains how the matching of clients and lawyers is facilitated through the combination of uniform CF rates and the referral system. It also points to the shortcomings of this system. A conclusion follows.

2 Related literature

A huge body of research has discussed the economics, sociology, psychology, and ethics of the market for legal services in general, and the CF market in particular (e.g. Spurr, 1987, 1988, 1990; Garicano and Santos, 2004; Kritzer, 2004; Parikh, 2001, 2006/2007; Zamir and Ritov, 2010, 2011; Brickman, 1989, 2003a, 2003b; Garoupa and Gomez-Pomar, 2008). Some of this research is particularly relevant to the present analysis.

One group of studies claims that the uniformity of CF rates is largely a product of lawyers' practices and that this uniformity entails that clients pay supra-competitive fees. Several commentators have argued that the uniformity of CF rates is due to lawyers' exploitation of clients' information problems and high search costs, exacerbated by lawyers' uniform pricing policy and the absence of price advertisements (Brickman, 1994, 2003b; Painter, 1995; Gross, 2006). It is, however, difficult to see how hundreds of thousands of lawyers manage to coordinate and enforce relatively uniform CF rates to the detriment of clients without any formal prohibitions on deviations from the standard CF rate.

Another group of studies explores the role of negotiable CF rates as a signaling or a screening device. Daughety and Reinganum (2011) show that offering different CF rates can serve lawyers as a signaling device regarding their private information about the value of the lawsuit. Dana and Spier (1993) similarly assume that lawyers compete for clients by offering different CF rates. Rubinfeld and Scotchmer (1993) and Cotten and Santore (2012) present screening models, in which lawyers have private information about their abilities, while all other case attributes are common knowledge, and clients offer a single contract that is acceptable only by a high-quality lawyer. A CF contract may thus provide a mechanism for revealing the quality of an attorney by allowing contracts that are only profitable to attorneys with a high likelihood of winning the case. Cotten and Santore (2012) also show that restricting the possible values of CF rates that a client can offer may prevent screening and reduce client welfare. A common difficulty of these screening models is their unrealistic assumption that clients have sufficient information about the expected value of their claim (and the number of hours required to handle it) for each type of lawyer. While these studies shed light on the CF market to the extent that CF rates are negotiable, they disregard this market's most salient feature, namely the distinctive, though not invariable, uniformity of CF rates. This feature is the focus of our analysis.

The third group of articles analyzes some implications of the uniformity of CF rates and comparable fee arrangements in other markets. Thus, Levmore (1993) argues that uniform CF rates induce providers of services to efficiently

allocate an appropriate amount of time to each assignment they undertake. Garicano and Santos (2004) analyze the referral system, focusing on the incentives for lawyers to refer cases to more-qualified colleagues under different profit-sharing schemes. However, they discuss neither the role of clients in this process nor the effect of the uniform CF rates on the matching of cases and lawyers. Finally, Sykes (1993) argues that uniform brokerage fees assist property owners in finding the most suitable broker for their property, based on the listing price proposed by each broker. While Sykes's analysis points to a linkage between uniform fee rates and the matching of clients and service providers, his mechanism is inapplicable to CF in the lawyers' market, as lawyers do not propose anything akin to a listing price. Thus, while the studies in this third group discuss the same (or comparable) phenomenon as we do, they do so from very different angles and under different assumptions.

A fourth group of studies consists of several works that theoretically and empirically examine the pairing of clients and service providers in the underwriting and investment markets. These examinations differ markedly from the one we offer. For instance, Fernando et al. (2005) analyze assortative matching of firms and underwriters, but fees do not play any role in their model. Chen and Ritter (2000) argue that the high, uniform commissions paid to underwriters of initial public offerings in the United States are supra-competitive and examine several explanations for this fact (which differ from ours). The selection of investment banks and the fees they charged were also empirically studied by Dai and her co-authors (Dai et al., 2010).

While all of these studies shed important light on the CF market, none of them provides a compelling positive or normative analysis of one of its salient features: the uniformity of CF rates. As a first step in this direction, the next section describes a simple model.

3 The model

The client, a would-be plaintiff, whom we initially assume is risk-neutral, wishes to hire a lawyer on a CF basis to represent her in a lawsuit to recover some damages. There are n lawyers, ranked according to their quality along a scale (1, 2, ... n), such that the higher the lawyer's ranking i is, the more qualified she is.[1] The

1 Note that the ranking of lawyers may – and usually does – depend on the type of claim. Thus, Lawyer A may be ranked higher than Lawyer B in medical-malpractice cases while B is ranked higher in car-accident cases. It follows that reciprocal referrals between two lawyers may both be to a higher-ranking lawyer (Parikh, 2001:156-158). See also Section 5.2

lawyer's quality (and ranking) carries two implications. First, for a given lawsuit, the more qualified a lawyer is, the higher the expected recovery (the amount recovered multiplied by the probability of recovery).[2] We assume, for simplicity, that the lawyer's quality does not affect the amount of work required for handling the case, h (while we measure the amount of work by the working hours put into the case, h can be understood as including other aspects of the lawyer's investment in the case as well). For any given case, h is thus uniform across all lawyers. It is further assumed that the CF scheme provides all lawyers with sufficient incentive to invest this amount of work in the case should they decide to represent the client. Second, the more qualified a lawyer is, the higher her hourly rate is. The lawyer's reservation hourly fee determines the minimum effective hourly fee for which she is willing to take a case.

Thus, under a CF arrangement, the lawyer, who maximizes expected value, calculates her effective hourly fee for each case, based on her expected benefit and the amount of work it will require. The lawyer will be willing to take the case if and only if it is expected to yield an effective hourly fee which is not lower than her reservation price.

For a given lawsuit, denote:

- w_i: Reservation (effective) hourly fee of lawyer i.
- h: Number of hours required to handle the lawsuit.
- p_i: Probability of success if lawyer i handles the case and allocates h hours to it.
- d_i: Value of recovery if the case is handled by lawyer i, provided she allocates h hours to the case.
- r: CF rate.

If the client is fully informed, she can determine the optimal CF rate for the specific contract, based on the following tradeoff: On one hand, the client prefers a lower CF rate to save on attorney fees. On the other hand, a higher rate would enable the client to hire a better lawyer (or any lawyer at all, if the expected recovery is very small), and strengthen the lawyer's incentive to attain the best outcome. However, in practice, clients do not have sufficient bargaining power to dictate the CF rate in their contract. More fundamentally, clients typically are not sufficiently informed to determine what CF rate is optimal for their case. Even if the client knows the general range of the expected value of

2 In fact, the expected recovery is determined by the distribution of the possible sums of recovery. In a discrete setting, it is an aggregation of the products of each sum and the likelihood of its recovery, and in a continuance setting, it is the integral over the probability density function.

her lawsuit, she is typically uninformed about the expected value of her lawsuit if handled by each specific lawyer and about the amount of work it will require, h. An evaluation of these values requires legal expertise that the client lacks, as well as data about each lawyer's specific characteristics, which is private, unobservable information.

We initially assume, however, that the client does know the lawyers' ranking. Potential clients may be able to rank lawyers according to proxies, such as how many associates she employs, where her offices are located, and (in the rare instances this datum is available) her hourly fee. The model thus captures the intermediate situation between the case in which the client has full information about both her claim and different lawyers' abilities (a rare possibility in the CF market), and the case in which the client knows neither the expected value of her claim nor the lawyers' abilities (a state of affairs discussed in Section 5). We also assume that clients do not face search costs.

Unlike the clients, we assume that the lawyers are fully informed. Specifically, we assume that a lawyer can accurately evaluate the expected value of the client's lawsuit if handled by her, and the amount of work it will require, h.[3] We also assume that each attorney can handle all of the cases that yield an effective fee which is at least equal to her reservation fee and does not have to choose among them.[4]

Each lawyer thus faces the following lottery:

$$(rd_i - w_i h, p_i;\ -w_i h, 1 - p_i)$$

with the expected value:

$$p_i[rd_i - w_i h] - (1 - p_i)w_i h = rp_i d_i - w_i h$$

Thus, the lawyer will take the case iff $rp_i d_i - w_i h \geq 0$, that is, iff

$$\frac{rp_i d_i}{h} \geq w_i$$

Assume first that CF rates are negotiable. Given our assumption about the parties' information, the lawyer has an incentive to take advantage of the would-be client's incomplete information by charging a CF rate that is likely to yield an

3 In the next section, we discuss the plausibility of this assumption, which is shared by others. See, e.g., Dana and Spier (1993); Brickman (2003b:94-95); Daughety and Reinganum (2011).

4 This is a very plausible assumption, because the lawyer's reservation hourly fee is not exogenous, but determined according to the demand for her services. If the demand for the services of a certain lawyer exceeds her capacity, one would expect her reservation hourly fee to increase accordingly.

effective hourly rate higher than her reservation hourly fee. Even if the client knows that Lawyer A is better than Lawyer B, the client cannot rationally compare Lawyer A's offer to handle the case for a CF rate of a to Lawyer B's offer to take the case for a lower CF rate b. Therefore, it is not only the case that the lawyer can charge a CF rate that yields an effective hourly rate higher than her reservation hourly fee, but the client may also end up choosing Lawyer B despite the fact that this alternative is suboptimal for the client.

Next, consider the case in which CF rates are uniform. The uniformity of CF rates provides the client with the power to make what is in essence the equivalent of a credible "take-it-or-leave-it" offer when choosing her attorney. Lawyers are induced to accept the offer whenever the case generates an effective hourly rate which is not lower than their reservation price. The uniformity of CF rates thus prevents lawyers from taking advantage of clients' information problem.

Under the uniform CF rate, the more qualified her lawyer, the better off the client, since moving up the ladder increases the client's net expected recovery. Given that the fee is calculated as a fixed rate of actual recovery, the client is indifferent as to whether the marginal effect of hiring a more-qualified lawyer (the increase of $p_i d_i$ as a result of a marginal increase in the lawyer's quality) is greater than the marginal increase in the wage (the increase in $w_i h$). Thus, the optimal strategy of a client who knows lawyers' rankings is to offer the case to the highest-ranking lawyer; if she turns down the case, the client should offer it to the next lawyer in rank, and so on, until she finds a lawyer willing to accept it. Alternatively, the client could invite lawyers to bid for the case (for the uniform CF rate) and choose the highest-ranked one to submit a bid.

The uniformity of the CF rate provides the client with the transaction's entire surplus. Consequently, except for extreme cases in which even the highest-ranking lawyer is willing to take the case (and possibly earn a fee higher than her reservation price), the uniformity of the CF rate enables the client to hire a lawyer for a fee equal to the lawyer's reservation hourly fee. To obtain the best lawyer available, that is, the best lawyer among those whose reservation hourly fee is lower than the effective hourly fee of the specific case, the client does not have to know the net expected value of the lawsuit under each lawyer; all she needs to know is the lawyer's ranking.

The result is a "positive assortative matching." As indicated above, in such equilibrium, the uniform CF rate does not yield uniform fees to different lawyers. Lawyers and cases are matched such that the effective hourly rate in all the cases a lawyer handles is equal to the lawyer's reservation hourly fee. Thus, for the given CF rate (e.g. one-third of the recovery), each lawyer has her own set of cases, and clients are induced to search for this lawyer to achieve the best

matching.[5] Good lawyers are hired to handle cases which yield high effective hourly fees, and lesser lawyers handle lower-value cases. The uniform CF rate may be different than the optimal one given the client's specific preferences. However, in light of the information asymmetry, from the clients' perspective a uniform CF rate may well be a second-best solution.[6]

4 Discussion

This section discusses empirical findings that support the model's assumptions and predictions, as well as the model's limitations.

4.1 Matching and heterogenic effective fees – empirical findings

Uniform CF rates would be a mystery if all cases were similar while lawyers varied in the quality of the services they provide. In the same vein, uniform CF rates would be puzzling if all lawyers were equally qualified while cases varied in their expected recovery. However, since both the value of cases and the qualification of lawyers are heterogeneous, uniform CF rates do not yield uniform effective fees (cf. Dai et al., 2010). If better lawyers handle more lucrative cases, uniform CF rates actually entail systematic differentiation in attorneys' fees (cf. Mnookin, 1998:367-368). In this equilibrium, plaintiffs with particularly strong cases, where the anticipated recovery is particularly large, are matched with more skilled lawyers, who can obtain for the client a higher expected value; plaintiffs with the second-most lucrative cases pair with second-best lawyers; and so forth. The high value of the case is likely to result in an especially large fee for the top lawyer, and the high quality of legal services is expected to result in a particularly large net recovery for the plaintiff with the lucrative case, without deviating from the standard CF rate. At the other end of the scale,

5 A comparable claim can be made regarding any sub-market in which lawyers charge other uniform CF rates, such as a non-negotiable variable fee depending on how the case is resolved (e.g. 25% if it is settled without trial, 33% if it goes to trial, and 40% if there is an appeal), provided that the probability of settling/trial/appeal is uniform for all attorneys.

6 Note that this result differs from the standard result in the literature regarding two-party negotiation under asymmetric information. According to the standard result, efficiency requires that the informed, rather than the uninformed, party would make the contract offer (e.g. Wang, 1998; Bolton and Dewatripont, 2005:243).

low-quality cases are expected to match with low-quality lawyers, thus yielding a smaller net recovery for the plaintiff and a minimal fee for the lawyer.[7] In such a market, the uniformity of fees is nothing but an optical illusion. In fact, the effective fees in the CF market may be as varied, and possibly more varied, than the hourly and global fees in other markets.

The hypothesis that the CF market is characterized by this type of "positive assortative matching" is supported by a large-scale study of Texas plaintiff lawyers conducted by Stephen Daniels and Joanne Martin. Daniels and Martin (2002) describe a hierarchical plaintiff bar. The "Bread and Butter" lawyers at the bottom of this hierarchy ordinarily deal with low-value cases, while the "Heavy Hitters" at the top handle very large cases. Sara Parikh (2001:59-61) provides a comparable description of the CF market in Chicago. The lawyers in these categories, as well as the intermediate ones, differ with regard to the mean value of the cases they handle, with the mean and median cases ranging from several thousand dollars to several million. These categories also differ with regard to the scope of the geographic market the lawyers serve (local, regional, or state/national) and the percentage of potential clients they turn away.

Moreover, the empirical findings also support the bargaining process described by our model, given a uniform CF rate. According to Daniels and Martin (2002:1789), while the Bread and Butter lawyers in their sample signed a CF contract with 35.1% of their potential clients (the median being 30%), those at the top contracted with only 17.9% (with a median of 10%). A similar pattern emerges from Parikh's (2001:75-78) empirical study. While "low-end" practitioners who handle personal injuries in Chicago accepted 49% of the cases they screened, "high-end" (the top 19%) and "elite" (top 1%) practitioners accepted 36% and 24%, respectively (see also Schwartz, 2012:357-371). The very high rate of rejection by top lawyers (more than four-fifths or three-fourths of potential clients, according to these studies) and the slightly smaller rejection rate of the next tier of practitioners (about two-thirds according to Parikh's data) dovetail with our model. Some potential clients do seem to have a good sense of the relative quality of lawyers. These individuals sensibly try to hire the top lawyers, and when they are turned down because their case is not lucrative enough, they approach lower-ranked lawyers, until they find an attorney willing to handle the case.

7 This insight, originally offered by Zamir and Ritov (2008), was endorsed by Furgeson (2009:824) and Gryphon (2011).

4.2 Information asymmetry

Some studies assume that potential clients are fully informed about the merits of their case (e.g. Rubinfeld and Scotchmer, 1993; Cotten and Santore, 2012). Contrary to these studies, and following others (e.g. Dana and Spier, 1993; Brickman, 2003b:94-95; Daughety and Reinganum 2011), our model assumes that lawyers are much more knowledgeable than clients not only regarding the services they provide but also regarding the merits of the client's case. We believe this assumption is much more realistic.

Indeed, prior to the initial interview, usually the client has private information about the circumstances and outcomes of her injury, while the lawyer is much more knowledgeable about the pertinent legal rules and about her services. By the end of the interview, however, and prior to concluding the representation agreement, the lawyer is likely more knowledgeable than the client not only regarding her services, but also regarding the merits of the case and the potential recovery.

At the contracting stage, both the lawyer and the client may wish to convey information to each other in a way that would improve their bargaining position. For instance, a client who strives to convince a high-quality lawyer to take her case may overstate the severity of her injury and understate the contribution of her fault to the accident. A lawyer may overstate the complexity of the case and underestimate the probability of winning it. There is, however, an important difference between the parties in terms of their ability to hide or misrepresent information. Typically, the scope of the lawyer's work and the ex ante probability of winning the case will remain unobservable and unverifiable throughout the parties' relationship, hence the lawyer can easily manipulate this information. In contrast, the details concerning the scope of injury and the circumstances of the accident are expected to be revealed subsequently if the lawyer accepts the case, hence the client knows that she cannot overly misstate the facts. The lawyer's superior experience and expertise enable her to extract the pertinent information from the client much more than the client is able to obtain the necessary information from the lawyer.

These observations are more plausible when clients are unsophisticated, single-shot players, than when they are sophisticated, repeat players. These observations explain why uniform CF rates, and the very use of CF arrangements, are considerably less common among corporate clients (plaintiffs and defendants), who typically know more about the merits of their case and can better monitor the attorney's efforts. In addition, while our model assumes absolute uniformity of CF rates, in reality there are some deviations from the standard rate. Plausibly these are the cases in which clients are particularly well informed.

4.3 Stability of the equilibrium

A difficult question is what prevents the parties from deviating from the uniform CF rate. Such deviations may be mutually beneficial. A lawyer would presumably find it advantageous to take a particularly lucrative case at a lower-than-standard CF rate, lest the client go elsewhere. At the same time, a client might find it advantageous to offer a higher-than-standard CF rate to induce a certain lawyer to take a case she would not otherwise take. As indicated, we do not rule out this possibility of deviation from the standard one-third CF rate, and indeed, some deviations do exist. Nevertheless, there are relatively few such deviations, and our model helps to understand this reality.

To begin with, several factors constrain the range of mutually beneficial possible CF rates. An overly low CF rate might dilute the lawyer's monetary incentive to attain the best outcome (on the incentive effects of CF arrangements, see, e.g. Schwartz and Mitchell, 1970; Miller, 1987; Thomason, 1991; Rickman, 1994; Polinsky and Rubinfeld, 2003; McKee et al., 2007). At the same time, there may be a "fairness constraint" on charging very high CF rates (Zamir and Ritov, 2011). The specter of a possible regulatory intervention may also induce lawyers to avoid very high CF rates (Brickman, 2003b; Zamir and Ritov, 2011:27-29). Within these constraints, it is not surprising that the standard flat CF rate is 1/3, a fraction with a small denominator that is a natural focal point (Shelling, 1960:67).[8] This is particularly true given both the relational character of the client–lawyer contract, where the reduction of confrontations in bargaining is particularly important (Bernstein, 1993:70),[9] and the futility of trying to negotiate a slightly higher or lower CF rate when the costs and prospects of the case cannot be calculated with much precision ex ante. Finally, as further explained below, lawyers have an interest in keeping the CF rates uniform, as this uniformity facilitates the referral system, because unsophisticated clients tend to assume that they can only gain from a referral: paying the same exact fee to secure the services of a better lawyer.[10]

Given the limited range of mutually beneficial CF rates and the behavioral and other factors that make one-third a natural focal point, some deviations

8 The same tendency is manifest in variable-percentage CF rates, where the common pattern is a scale of rates of 1/4, 1/3, and 2/5 or 1/2, depending on the stage to which the case gets. It is also manifest in the common referral fees, where, according to one study, some 80% of the negotiated referral fee rates are either one-third or one-half of the handling lawyer's fee (Spurr, 1988:100-102).

9 In Kritzer's survey, 25% of the individual clients and 33% of the organizational ones reported that fees were not discussed at all with the lawyer prior to receiving the bill (Kritzer, 1990:57).

10 See Section 5.1. In Section 5.5., we will explain why this naïve assumption is problematic.

from this standard may nevertheless seem attractive to the parties and thus merit consideration. Clearly, a lawyer has no incentive to offer a CF rate lower than one-third if it would yield an effective hourly fee that is lower than her reservation price. A more difficult question is what will be the result if a lawyer offers to handle a case for a lower-than-standard rate when a higher-ranking lawyer would be willing to accept the same case for the standard rate. If successful, this strategy may result in an effective hourly fee that is higher than her reservation price. Attorneys who do not know whether the client is aware of their ranking would, however, be reluctant to offer a lower-than-standard CF rate because this would indicate that they are less qualified than their colleagues – a message they would be loath to send (Silver, 2002; Brickman, 2003:101-102). Moreover, clients are unlikely to accept such offers anyway. As indicated, clients are typically unable to assess the expected value of their claim and the expertise it might require. As a result, they cannot tell whether it is preferable to engage a higher-ranking lawyer for a CF rate of one-third or a lower-ranking one for a lower rate.

While this incomparability makes it difficult to predict the client's choice, there are several reasons to assume that clients would rarely opt for the lower-ranked lawyer charging the lower-than-standard CF rate. First, hiring a better lawyer plausibly entails not only a higher expected recovery but also a higher likelihood of winning the case. Hence, risk-averse clients (as single-shot personal-injury plaintiffs usually are) are likely to prefer the better lawyer, who charges the standard rate.[11] Second, people tend to assume that the prevailing rate is reasonable. They treat the common fee as a benchmark for judging fairness (Brickman, 2003b:99; cf. Zamir, 1997:1758-1759) and feel secure in the knowledge that their agreement conforms to the prevailing norm (Epstein, 1992:10). The more widespread the adherence to a background norm, the likelier it is that a suggestion to deviate from it will make the other party suspect hidden motives (Ben-Shahar and Pottow, 2006:667). Third, the standard CF rate likely

11 To see why, suppose that the expected returns to the client from the two lawyers are the same. Specifically, denote by k the CF rate, p the probability of success, and d the amount of recovery. The client's expected return from the better lawyer is $(1–k)pd$ while the expected return from the lower-ranked lawyer who charges a lower CF rate is $(1–k')p'd'$, where $k > k'$, $p > p'$, and $d > d'$. Assuming, without loss of generality, $u(0) = 0$, we obtain that the expected utilities of the two returns are $pu((1–k)d)$ and $p'u((1–k')d')$. We assume that $(1–k)pd = (1–k')p'd'$. It follows that $p' = (1–k)pd/(1–k')d'$, and the expected utility of hiring the lower-ranked lawyer becomes $(1–k)pdu((1–k')d')/(1–k')d'$. The expected utility from the better lawyer is higher than that from the other lawyer iff $\frac{u((1-k)d)}{(1-k)d} > \frac{u((1-k')d')}{(1-k')d'}$

This inequality holds because by $(1–k)pd = (1–k')p'd'$, together with $p > p'$, we obtain that $(1–k)d < (1–k')d'$, and since u is concave and $u(0) = 0$, the ratio $u(x)/x$ decreases with x.

creates a default effect, that is, a tendency not to opt out of default arrangements, whether or not one judges them to be fair (see generally Zamir, 1997; Korobkin, 1998; Madrian and Shea, 2001; DellaVigna, 2009:322-323). This phenomenon is particularly manifest when people face choices involving risk or uncertainty (e.g. Bar-Hillel and Neter, 1996), as is the case in the present context: a lower CF rate may either increase the client's net recovery (because her share will be larger), or decrease it (because the gross recovery might be smaller due to the dilution of the lawyer's incentive) (see, e.g. Santore and Viard, 2001:550).

4.4 Risk aversion

Our model assumes that both lawyers and clients are risk-neutral. The assumption that lawyers working on a CF basis are risk-neutral is plausible since they handle many cases. In contrast, since clients in the CF market are usually private people who are single-shot players, they are more plausibly risk-averse. In fact, risk-shifting is one of the basic justifications for the CF arrangement (Brickman, 1989; Kritzer, 2004; Posner, 2007:613-614).

If the client and lawyer differ in their attitude to risk, the strategy of choosing the best lawyer willing to handle the case for the standard CF rate may be less than optimal for clients. Risk-neutral lawyers decide whether to take a case according to its expected value, $p_i d_i$. However, a risk-averse client may prefer an increase in the probability of recovery even if this entails a decrease in the expected recovery. Choosing the highest-ranked lawyer willing to take the case thus maximizes the client's expected value, but not necessarily her expected utility.[12]

It seems, however, that this concern is mostly theoretical. For one thing, it stands to reason that a higher-ranking lawyer will be better not only at achieving a higher expected recovery, but also at assuring a higher likelihood of winning the case or attaining a favorable settlement. For another, assuming decreasing marginal productivity of the time and effort a lawyer puts into a case

12 For instance, hiring a particular lawyer may yield a relatively low p and high d, whereas hiring a less-qualified lawyer would yield a lower expected value $p'd' < pd$, but may result in higher probability of winning the case ($p' > p$), which might be sufficient to compensate the risk-averse client for the lower expected value. In addition, a risk-averse plaintiff may be more interested in establishing the defendant's liability than in the scope of damages awarded, and if a particular lawyer is better at attaining high damages once liability is determined, but not in proving liability, the client may be better off with someone else.

(appreciably, beyond a certain minimum), a CF arrangement is likely to induce lawyers to accept settlement offers rather than invest additional time and effort in trying to attain a higher recovery. This is because under the standard CF rate, the lawyer recoups only one-third of the added value of any additional hour she puts into the case (Schwartz and Mitchell, 1970; Miller, 1987; Thomason, 1991; Rickman, 1994:43-45). Under CF arrangements, lawyers are thus expected to act rather cautiously, a tendency that is likely to accord with the preferences of a risk-averse client. This incentive effect of the CF arrangement plausibly narrows the possible gap between the parties' risk aversion (and may even reverse it).

4.5 Varying the amount of work

The argument that uniform CF rates induce a desirable matching is based on the assumption that all lawyers expect to invest the same amount of work, h, in handling the case.[13] This assumption guarantees that the lawyers' ranking according to w_i corresponds to the expected value of the case, $p_i d_i$.[14] While the uniformity of CF rates ensures that the lawyer would not have an incentive to suboptimally allocate her time and effort among the cases she handles (Levmore, 1993:505-511), it does not rule out the possibility that different lawyers would optimally spend varying amounts of time and effort on the same case. In particular, it is possible that a more-qualified lawyer would prefer to invest fewer resources in the case (and thus generate a lower expected value for the client) than a lower-ranking lawyer would. If so, the client would not be able to rely on lawyers' ranking, but instead would have to calculate the value of $p_i d_i(h_i^*)$ for each lawyer (where h_i^* is the amount of work a lawyer i is expected to invest in the case).[15] Potential clients do not typically possess the information necessary for such a calculation. Here, too, however, it seems plausible that given the incentive effects of a uniform CF rate, the clients' assumption that a more-qualified lawyer would attain a larger recovery is quite reasonable.

13 The actual scope of work required ex post may of course differ from the scope expected ex ante, but since there is no difference in this respect between negotiated and uniform CF rates, the model assumes away this possibility.

14 Conceivably, the ranking would have been different had the pricing scheme, and thus the incentives it provides, been different.

15 This is especially true if the lawyer's input includes not only hours of work but also other aspects of her "production function," which are often unobservable.

4.6 Search costs

Contrary to the model's assumption, search costs are never actually zero. These costs are nevertheless quite low, since lawyers do not ordinarily charge clients for reviewing a case before deciding whether to accept it. Often, it takes the client just a phone call to realize that she aimed too high in her search for an appropriate lawyer (Kritzer, 2004:76-89). Introducing search costs to the model would provide lawyers with some bargaining power. Thus, in certain instances lawyers would be able to extract effective hourly fees that exceed their reservation value, and the client might not be able to hire the best-available lawyer. However, as long as search costs are not prohibitively high, our results hold.

4.7 Clients' knowledge of lawyers' ranking

The strongest assumption of the model is that potential plaintiffs possess complete information about the ranking of all lawyers. While this assumption might be true for particularly knowledgeable clients, it does not hold for most unsophisticated, one-shot plaintiffs. Section 5 will analyze the referral mechanism through which unsophisticated clients are matched with lawyers. However, it is worth noting that this limitation of our model is plausibly less dramatic than this critique implies. It stands to reason that for most cases, small differences in lawyers' qualifications would have very little effect on the plaintiff's recovery. Consequently, to attain the desirable matching, suffice it that the potential plaintiff can rank a limited number of lawyers into a limited number of quality groups. The fact that for many claims different lawyers may be equally effective thus does not weaken the force of our argument; it strengthens it.

4.8 Efficiency

The model assumes that for a given lawsuit, the more qualified the lawyer, the higher the expected recovery. While this assumption is sufficient to ensure that the client would hire the best-available lawyer, it does not guarantee that the ensuing matching would maximize overall social welfare. Two concerns should be addressed. First, from a social point of view, the optimal lawyer to handle a given lawsuit is not necessarily the one who would obtain the highest expected recovery, but rather the highest expected *net* value. Assume, for instance, that Lawyer A's reservation fee is $300, and that if she were to handle the case, the expected recovery would be $900. Lawyer B's reservation fee is $150, and if she

were to take the case, the expected recovery would be $800. Given a CF pricing scheme, the client is clearly better off hiring Lawyer A, who would agree to take the case at the standard CF rate of one-third. However, the efficient outcome is to assign Lawyer B to the case, as this would yield a higher expected net value ($650 with Lawyer B vs $600 with Lawyer A). Thus, a matching is socially optimal only if the marginal productivity of quality (the increase in expected recovery when a better lawyer handles the case) is not only positive but also higher than its marginal cost (the increase in the lawyer's reservation fee when a more-qualified lawyer is hired). When this assumption does not hold, the uniform CF rate may be in the best interest of the client, but is not necessarily the socially optimal option.

A second concern from a social welfare perspective has to do with which cases attorneys choose to handle. Suppose, for example, that the expected recovery in case A is higher than in case B, but the quality of the lawyer will have a greater impact on the expected recovery in case B (since, for instance, establishing liability requires especially finely honed legal skills) (cf. Mnookin, 1998:368). If case A is expected to yield an effective hourly fee at least equal to the lawyer's reservation fee, while case B is expected to yield an effective hourly fee lower than her reservation fee, then given the uniformity of the CF rate, she would accept case A and turn down case B. She would do so even if from a social perspective she could add more value to case B.[16] Here again, the attained matching does not induce the most efficient outcome. However, it is unclear that absent a uniform CF rate, client B – who is presumably neither conversant with the expected value of her lawsuit if handled by each lawyer nor aware of how much work her case will require – would be willing to pay a higher CF rate to attain a better lawyer, as she cannot know whether hiring the better lawyer would indeed result in a higher net recovery. Instituting a negotiable CF rate market would not eliminate this inefficiency.

Despite the limitations of the basic model's assumptions – that clients are risk-neutral and that different lawyers would put the same amount of time and effort into the same case – the empirical findings described in Section 4.1 seem to indicate that our model adequately captures some aspects of the CF market. The central limitation of the model lies, however, with its assumption that potential plaintiffs know the ranking of the attorneys who are appropriate for their case. Very often, this is not true. Potential plaintiffs who lack this information may be assisted by people who possess it (and possibly have the additional

16 If both cases are expected to yield an effective hourly rate that is not lower than the attorney's reservation price, then it may reasonably be assumed that she will accept both. See supra note 4 and accompanying text.

information necessary to choose the optimal lawyer given varying h) – namely, other lawyers. The next section will analyze the mechanism through which clients may obtain this assistance (and sometimes pay for it): the referral system.

5 Uniform contingent-fee rates and referrals

5.1 General

The above analysis assumed that clients are aware of lawyers' ranking. Often this is not the case, as the majority of tort plaintiffs are single-shot players who are unfamiliar with the pertinent legal-services market. Such plaintiffs may benefit from transferring their case from the lawyer they initially approached to a more suitable one. The *raison d'être* of the referral mechanism is to compensate for the typical client's lack of knowledge about lawyers and the value of her own case. Referring lawyers are considerably more knowledgeable than laypeople when it comes to other lawyers' capabilities and the potential value of cases (Spurr, 1988; Parikh, 2001:59, 120, 170, 2006/2007:252, 257; see also Abel, 2006/7:351-352, 355).

Empirical studies show that while most clients in the CF market find an attorney by themselves, many – especially those who want to put their case in the hands of a high-quality, expert attorney – rely on referrals. According to Daniels and Martin (2002:1783-1795), while the Bread and Butter lawyers acquire 20% of their clients through referrals from other lawyers, the Heavy Hitters acquire most of their clients (55.3%) this way. In the same vein, Parikh estimated that "[f]or attorneys in the low-end sector, about one-third of their business comes from other attorneys. By contrast, attorney referral generates about two-thirds of the business for attorneys in the high-end and elite sectors" (Parikh, 2006/2007:254). Similarly, in Spurr's (1988:94) sample, high-quality lawyers obtained 52% of their cases from other lawyers, as compared to an average of 27% in the entire sample (see also Daniels and Martin, 1999:385-388). Although attorney referrals play a greater role in the practice of high-end lawyers, these lawyers will sometimes refer low-value cases to low-end lawyers (Parikh, 2006/2007:248).

The uniformity of CF rates fosters the referral system by assuring clients that they will not have to pay a higher fee if their case is transferred to a more suitable lawyer. Unsophisticated clients likely assume that the referral only affects the handling lawyer's fee, not their own net recovery. While attorneys presumably inform clients about fee splitting (Rule 1.5(e)(2) of the ABA Model

Rules of Professional Conduct (2002)), clients may assume that since the referral fee is paid out of the handling lawyer's share of the recovery, it does not affect their own net recovery. Were CF rates negotiable, clients would sensibly worry that if the case is transferred, they would have to pay a higher fee. Moreover, were it considered legitimate to charge higher CF rates when the case is transferred, even equally qualified attorneys would find it profitable to reciprocally refer cases of uninformed clients, thus charging higher total fees. Lawyers who benefit from the referral system thus generally have an interest in maintaining the standard rates.

For the reasons discussed below, the naïve assumption that the client can only gain from the referral when CF rates are uniform is incorrect. Nevertheless, we claim that this scheme has important advantages for clients. This section discusses the advantages and pitfalls of the referral system when CF rates are uniform. It concludes that while the referral system with uniform CF rates is a second-best solution for the clients' lack of information, this system is not necessarily inferior to other conceivable solutions, such as a ban on fee splitting, varying CF rates, and other mechanisms of brokerage in legal services.

The referrals practice is not uniform. A significant number of referrals, in particular top-down ones, are done for no fee (see Section 5.4). When a referral involves fee splitting, the fee is calculated as a certain percentage of the handling lawyer's net recovery. In the United States, the referral fee is ordinarily negotiated between the referring and handling lawyers and is usually one-third or one-half of the latter's fee (Spurr, 1988; Parikh, 2001; Brickman, 1989:109, 2003b:88-89). In other legal systems, such as Israel, referral fees are (or at least used to be) rather uniform: ordinarily one-third of the CF. In what follows we will briefly analyze these three schemes in reverse order: starting from a uniform referral fee and ending with unpaid-for referrals. We will also challenge the claim that the uniformity of CF rates paid by clients whose cases were transferred for a referral fee and those who found a suitable attorney on their own indicates that the standard rate is supra-competitive, at least for the latter (Brickman, 2003b:88-89).

5.2 Uniform referral fees

When both CF rates and referral fee rates are uniform, the matching process modeled in Section 3 applies mutatis mutandis. The client, who does not know lawyers' ranking, is assisted by the referring lawyer, who does. The referring lawyer finds the best attorney willing to handle the case for the standard CF rate minus the standard referral fee rate. This mechanism is expected to function

regardless of whether the transfer is up or down the scale. The referring lawyer is making a de facto "take-it-or-leave-it" offer to potential handling lawyers, transferring the case to the highest-ranking lawyer who agrees to take it on.

To identify the conditions under which such transfers are likely to occur, the following model analyzes the lawyers' behavior in a market where both CF rates and referral fees are uniform. Without loss of generality, assume that the uniform CF rate is one-third of the recovery and the uniform referral fee is one-third of the CF (that is, the handling lawyer gets two-ninths of the recovery and the transferring lawyer one-ninth). Following the above notations, for a case to be transferred two conditions must be met. First, the would-be transferring lawyer would transfer it iff:

$$\frac{p_i d_i}{3} - w_i h \leq \frac{p_j d_j}{9} \quad [1]$$

where i is the transferring lawyer and j is the prospective handling lawyer. The handling lawyer would be willing to accept the case iff:

$$\frac{2p_j d_j}{9} - w_j h \geq 0 \quad [2]$$

First, consider referrals to a more-qualified lawyer. It is clearly in the client's interest that a case be transferred to a better lawyer who is willing to handle it, whenever such a person exists. This outcome is obtained when both conditions are met. Condition [1] is met when the lawyer's expected profit from handling the case is lower than one-ninth of the expected recovery if the case is handled by the transferee. In these circumstances, the lawyer has an incentive to transfer the case to the best-available lawyer, as this would maximize her own expected referral fee (as well as the client's net expected recovery). When condition [2] is met for some $j > i$, the desirable transfer will take place.

The referral system imposes an additional cost of the referral fee of one-ninth. This is a direct cost, tantamount to that of brokerage fees. Consequently, the best lawyer who would have been willing to take a case for one-third of the recovery would not take it for two-ninths, and the case would instead go to a lower-ranking lawyer. Another constraint is that if condition [1] is not met, the would-be transferring lawyer would find it unprofitable to transfer the case, although there is a better lawyer j that would have been willing to handle the case and increase the client's net recovery.

Next, consider transfers to a less-qualified attorney. If the client's first-choice lawyer is unwilling to take the case, clearly no higher-ranking lawyer would take it, and the desired course of action is to transfer the case to a lower-ranking lawyer. Here, too, two problems may arise. First, the pool of would-be

transferees is limited, since their expected net fee is only two-ninths of the recovery, rather than one-third. Accordingly, the lawyer who agrees to take the case will have a lower ranking than the lawyer the client could have hired without a referral. Second, even though the transferring lawyer could handle the case herself, she may prefer to refer the case to a less capable colleague. This would occur whenever the expected referral fee is higher than the transferring lawyer's net gain from handling the case. As a matter of fact, top-down referrals often involve no fee splitting (see Section 5.6).

To these advantages and limitations, one should add the incentive effects of fee splitting. A conspicuous disadvantage of fee splitting is that it dilutes the handling lawyer's monetary incentive to attain the best outcome for the client. Under a CF arrangement, the lawyer recoups only a portion of the added value of any additional hour she puts into the case, rather than the entire added value. The smaller this portion, the earlier the point at which the lawyer would find it unprofitable to put extra effort into the case. A net fee of two-ninths of the recovery provides a weaker incentive for the handling lawyer than the standard one-third.

The involvement of the referring lawyer may, however, mitigate this problem. The referring lawyer is typically a repeat player in the referral market and is considerably more knowledgeable than the typical client. Since her referral fee is a function of the sum recovered, she has an incentive to monitor the handling lawyer's performance. If the recovery seems unduly low, she might not refer future cases to the same attorney, thus providing the handling lawyer with an incentive to invest extra effort in the case.[17] Sometimes, the referring lawyer has ongoing relationships not only with the handling lawyer but also with the client, to whom she provides other legal services. If the client is ill-treated by the handling lawyer, she is liable to hold this against the referring lawyer and look for another lawyer for all of her legal needs. The transferring lawyer thus has a double incentive to choose the most suitable lawyer and monitor her performance (Spurr, 1988; Parikh, 2001; Kritzer, 2004:61).

This analysis also applies when the referring lawyer has a different specialization than the handling lawyer, for example, if she is a real-estate lawyer who had represented the client in a land transaction (Parikh, 2001; Kritzer, 2004:59). A conspicuous advantage of a referral by a lawyer outside of the pertinent ranking is that handling the case is not a viable option for her. Hence, the

17 At least in theory, the incentive created by the ongoing relationship between the referring and the handling lawyers may outweigh the reduction in incentives due to fee splitting – in which case finding an appropriate lawyer through a referral may be advisable even if the client is knowledgeable about lawyers' ranking.

referring lawyer has a monetary incentive to refer the case to the best-available attorney willing to handle the case for an effective fee of two-ninths of the recovery, regardless of whether the reservation hourly fee of that attorney is higher, lower, or equal to her own reservation price. The downside of a referral by a lawyer with a different specialization is that she might not be as capable of monitoring the handling lawyer's performance as a referring lawyer who handles similar cases would be.

Compared to referrals by non-legally-trained brokers, the current referral system thus has several advantages. First, the typical single-shot personal-injury plaintiff may not know whether she needs a referral. Approaching a lawyer who might or might not handle the case herself saves on referral fees whenever that lawyer is actually suited to handle the case. This is a considerable advantage given that most cases are not transferred.[18] Second, a legally-trained transferor is far better able to monitor the handling lawyer than a broker with no such training, and if the former has ongoing relationships with the client, she also has a stronger incentive to engage in such monitoring. While these arguments may not justify the prohibition on brokerage in legal services by non-lawyers, they do point to advantages of the current system. In any case, as far as we can see, there is no necessary connection between the uniformity of CF rates and the availability of such brokerage services.

Compared to a system where referral fees are prohibited, the fee-splitting system creates a much stronger incentive to transfer the case when the original lawyer is not well-suited to handle it. Absent referral fees, utility-maximizing lawyers would prefer to handle such cases by themselves, notwithstanding their knowledge that other lawyers could attain a much higher expected net recovery for the client.

5.3 Non-uniform referral fees

Some of the above arguments apply to markets in which CF rates are uniform but referral fees are non-uniform, which is the case for much of the CF market in the United States (Spurr, 1988). The concern that the payment of a referral fee narrows the pool of lawyers who might be willing to handle the case as well as the worry that it dilutes the handling lawyer's incentive to attain the best outcome also apply when referral fees are negotiable. The same is true for the

18 As detailed in Section 5.1, while top lawyers obtain most of their cases through referrals, the majority of lawyers, who handle the lion's share of the CF cases, obtain most of their cases directly.

arguments regarding the transferring lawyer's ability and incentive to monitor the handling lawyer. Negotiating for a lower referral fee would reduce the magnitude of the former concerns, yet diminish the referring lawyer's incentive to look for the best-suited attorney and monitor her performance. Negotiating a higher referral fee would have the opposite effects.

The main difference between uniform and negotiable referral fees is that, once referral fees are negotiable, the advantage of uniform CF rates in terms of inducing desirable matching no longer exists. When the referral fee is negotiable, the transferring lawyer's ability to make a credible "take-it-or-leave-it" offer to the potential transferee is considerably diminished. Inasmuch as the interests of the two lawyers are involved, this may not be a serious concern, as the referring lawyer is often capable of assessing not only the ranking of lawyers but also the scope and probability of recovery and the amount of work the case is likely to require. In fact, when both parties are fully informed, negotiable referral fees are superior to uniform ones. However, the negotiability of the referral fee means that the interests of the client and the referring lawyer may diverge. A transferring lawyer whose referral fee is negotiable may transfer the case to an attorney who offers her a larger referral fee, even if the latter is not the best-available lawyer for the case (Pauly, 1979; Gilson, 1990:896).

It may still be the case, however, that uniform CF rates with negotiable referral fees are superior to a system where both CF rates and referral fees are negotiable. This is because the latter regime lacks the advantage of uniform CF rates for clients who do not need a referral since they (at least roughly) know lawyers' ranking. As explained in Section 3, the uniformity of CF rates facilitates desirable matching despite clients' acute information problem regarding the value of their claim, the number of hours it might require, and so forth.

5.4 Unpaid-for referrals

Prohibiting referral fees altogether would eliminate the pitfalls of the current system, but as indicated, would hardly serve clients' interests or overall efficiency, as it would result in lawyers handling cases they should preferably transfer to more-qualified attorneys (Pauly, 1979; Parikh, 2001:120). If referring lawyers were not allowed to charge a referral fee based on recovery, they might also transfer the case to a lawyer who might not necessarily maximize the expected recovery.

Even when fee splitting is permissible, many referrals are done for free (Parikh, 2001; Kritzer, 2004:58-59). Lawyers may transfer a case to another lawyer without asking for a referral fee because they believe charging such a

fee is unethical, because the expected recovery is too small to bother with a referral fee (in which case, fee splitting might also render the case unprofitable for the handling lawyer), or as part of a strategy of encouraging reciprocal referrals. Lawyers also refrain from charging a referral fee when the reason for not handling the case by themselves is a conflict of interest (Parikh, 2001; Kritzer, 2004:58-60). Higher-ranking lawyers may also refrain from charging a fee when forwarding a case to a lower-ranking lawyer to avoid potential joint responsibility for the quality of representation (in the absence of actual joint handling of the case, such responsibility is a precondition for fee splitting under Rule 1.5(e)(1) of the ABA Model Rules of Professional Conduct (2002)).

Absent fee splitting, the pitfalls of uniform or negotiable referral fees, such as the reduction of the handling lawyer's monetary incentive to attain the best outcome, are eliminated. At the same time, so are the advantages of the paid-for referrals system discussed above. Thus, a lawyer may choose to transfer a case to her friend rather than to the best-available attorney (Spurr, 1988:91). Considerations of reputation, relationships, and reciprocity may nevertheless provide some alternative incentives for the transferor and the transferee to act in the best interests of the client.

5.5 Uniformity of contingent-fee rates whether or not referral fees are paid

Clearly, when the handling attorney splits the fee with the referring lawyer, her share of the gross recovery is considerably lower than when she retains the entire CF. The fact that clients who find the appropriate lawyer on their own and clients who are transferred for no fee pay the same CF rate as clients who are transferred for a referral fee is apparently inefficient and unfair. When a lawyer charges a client who directly approached her or was referred to her for no fee (hereinafter – a direct client) the same CF rate as a client who was referred to her by another lawyer for a fee, the former client seems to cross-subsidize the latter. Arguably, the transferred client purchases two services – referral and representation – for the same price the direct client pays for representation only. Not only do these uniform charges seem unfair to the direct client, it has also been claimed that they prove that the standard CF rate is supra-competitive due to lawyers' collusion (Brickman, 2003b:88-89; cf. Engstrom, 2011:865). Otherwise, lawyers would charge direct clients lower CF rates than transferred ones.

Even if it were true that direct clients pay the same fee for fewer services (representation without referral) it would not prove that the market is inefficient due to lawyers' behavior. It could be the result of the superior bargaining power

of clients, which prevents lawyers from passing on the cost of the referral fee to the transferred clients.[19] Contrary to the basic assumption of the model offered by Garicano and Santos (2004), in many cases (and probably most), the referring lawyer does not have the power to transfer a case unless (a) the handling lawyer has first examined and decided to accept it, and (b) the client has met with the handling lawyer and agreed for her to take the case (Parikh, 2001:145, 155, 158). If the handling lawyer were to ask the client for a higher-than-standard CF rate to compensate for the referral fee, the client would likely look for another attorney – now equipped with the knowledge that the case is rather lucrative.

Furthermore, while paid-for referrals yield lower net fees for the handling lawyer, there are also considerable costs involved in attracting direct clients. To build the type of reputation that would attract clients other than by referrals, high-ranking firms have to employ marketing techniques such as holding press conferences on important cases, writing editorials, nurturing amicable relationships with former clients, and so forth (Parikh, 2001:165-166; on customer's referrals as a marketing technique, see generally Hada et al., 2010). The costs involved in such activities may be rather substantial.

More fundamentally, the cross-subsidization argument is based on a misconception about CF and referral practices. While it is true that transferred clients pay the same CF rate as direct clients, the services the former get for, say, two-ninths of the recovery (one-ninth effectively being paid to the referring lawyer) are inferior to the services they would have received had they found a suitable lawyer by themselves. This is because direct clients can hire a considerably higher-ranking lawyer than clients referred for a referral fee. Where the referral fee is one-third of the CF, had the client found the appropriate attorney independently, she could have attained a lawyer whose reservation hourly fee was 50% higher.[20] Likewise, if the referral fee is one-half, by finding legal

19 Charging direct and transferred clients the same CF rate is analogous to a policy of uniform spatial pricing, where a seller charges a uniform delivered price for its goods regardless of the differences in transportation costs to customers in different locations. Such policy may be profit-maximizing under certain assumptions regarding demand functions (Lederer, 2010). For instance, if transferred clients are ordinarily poorer than direct ones – a plausible assumption given that their recourse to the referral system indicates that they are less sophisticated and knowledgeable – then the uniform pricing of the two populations may be a profit-maximizing strategy.

20 Take, for example, a case whose expected value, $p_i d_i$, is \$270,000 and the number of hours it requires, h, is 100. The expected fee under the standard one-third CF rate is \$90,000. A client who finds her own legal representation would hire an attorney whose reservation hourly fee, w_i, is \$900. In contrast, a client with the same case, who approaches an unsuitable lawyer who then transfers her case, can only expect a handling lawyer whose reservation hourly fee is \$600, as two-ninths of \$270,000 is \$60,000.

representation on her own, the client could have obtained a lawyer whose reservation hourly fee was 100% higher than that of the lawyer to whom she was referred. It thus makes perfect sense that direct clients pay the handling lawyer an effective net fee that is much higher than that paid by transferred clients.

The pertinent comparison is not between the direct and transferred client of a certain lawyer, but rather between the transferred client of Lawyer A and the direct client of the far more-qualified Lawyer B. In all probability, the direct client of the better lawyer receives correspondingly better representation, both because she has the superior lawyer and because the one-third CF rate provides her lawyer with a stronger incentive to attain a favorable outcome than the lower effective CF rate of the transferred client. From the handling lawyer's perspective, she is expected to attain the same effective hourly fee from both the direct and the transferred client: either one-third of the recovery or two-ninths (given a referral fee of one-third) of a proportionally larger recovery.

There is some empirical support for this analysis. Spurr (1988:93) found that in his sample, the average recovery attained by high-quality lawyers in cases referred to them by other lawyers was $113,224, while the average recovery obtained in other cases was $84,070. That is, the average recovery in the transferred cases was about 35% higher than in the direct cases. Based on Spurr's (1988:101) data, we calculated the average referral fee in his sample, which was about 45%.[21] Arguably, to earn the same effective hourly fee in the two types of cases, given an average referral fee of 45%, the difference in the average recovery should be considerably greater. However, if one assumes that attaining direct cases involves considerable marketing costs, these findings roughly accord with our analysis.

"Assortative matching" is thus a plausible solution not only to the uniformity of CF rates puzzle but also to the apparent puzzle of uniform CF rates paid by both transferred and direct clients.

6 Conclusion

Critics of the uniformity of CF rates and the current referral system sometimes implicitly compare the present situation to one in which all clients and lawyers are fully informed. This comparison is unhelpful, as many clients in the CF

21 Contrary to the prediction of his theoretical model, Spurr (1988:102-107) found no statistically significant correlation between the referral fee and gross recovery.

market suffer from an acute shortage of information. Most single-shot personal-injury plaintiffs are laypeople who are unable to evaluate the scope and merits of their claim, the amount of work it will require, and the quality of lawyers. These characteristics also make it highly unlikely that disclosure duties would effectively solve their information problems.

This article assessed the common argument that the uniformity of CF rates in the legal-services market is evidence of a market failure, possibly caused by lawyers' collusive practices. We claimed that the uniformity of CF rates does not necessarily adversely affect clients' interests or overall efficiency. Uniform CF rates facilitate a desirable matching of cases and attorneys when clients know lawyers' ranking, even if they cannot bargain for an optimal contract because they are unable to reliably assess the expected recovery and the scope of work their case may require. When clients do not know lawyers' ranking, desirable matching is likely attained through the referral system, with or without referral fees. When both CF rates and the referral fees are uniform, the referring lawyers, who are aware of the ranking, play a similar role to that of a client who possesses this information. Even when referral fees are negotiable, it is unclear that the referral system, despite its pitfalls, is any worse than the alternatives, such as banning or otherwise regulating referral fees, moving to negotiable CF rates, or having non-lawyers broker legal services.

The upshot of our analysis is that, given clients' inherent information problem, the current combination of uniform CF rates and the referral system is not a first-best solution. Nonetheless, it may well serve the interests of clients, and is not necessarily less desirable in terms of social welfare than other market schemes. Whether one is interested in overall efficiency or in enhancing clients' interests, the very uniformity of CF rates thus does not establish the case for regulating these rates or the CF market more generally. Since some clients know lawyers' ranking and thus benefit from the uniformity of CF rates, and others may not know how reliable their information is (and hence may or may not discover that they can benefit from a referral), moving to negotiable CF rates may adversely affect clients as a group.

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