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Bradley L. Smith
University of Michigan Law School

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Three Attorney Fee-Shifting Rules and Contingency Fees: Their Impact on Settlement Incentives

Bradley L. Smith

Mounting criticism of American litigiousness has drawn greater attention to the two prevailing rules concerning attorney fees and litigation.¹ The familiar American rule requires that each party bear its own fees,² while the British rule requires the losing party to pay the winner's attorney fees.³ The American rule has been attacked on grounds of inefficiency and unfairness. Opponents claim the rule promotes wasteful litigation expenditures, implausible claims, strike suits, onerous discovery demands, and spurious defenses.⁴ Moreover, the

1. Nearly 18 million civil lawsuits were filed in state and federal courts in 1989. PRESIDENT'S COUNCIL ON COMPETITIVENESS, AGENDA FOR CIVIL JUSTICE REFORM IN AMERICA 1 (1991) [hereinafter COUNCIL ON COMPETITIVENESS]. Federal District Court filings have nearly tripled since 1960. *Id.* It is estimated that U.S. businesses and governments spent over \$117 billion on direct litigation costs and higher insurance premiums in 1987; 1991 expenditures may have reached \$184 billion. Leslie Spencer, *The Tort Tax*, FORBES, Feb. 17, 1992, 40 at 40. Indirect costs, including measures to avoid litigation, increase the total to over \$300 billion annually. *Id.* at 42. Prominent critics of American litigiousness abound. See, e.g., JUDICIAL CONFERENCE OF THE UNITED STATES, REPORT OF THE FEDERAL COURTS STUDY COMMITTEE (1990); JETHRO K. LIEBERMAN, THE LITIGIOUS SOCIETY (1981); Derek C. Bok, *A Flawed System*, HARV. MAG., May-June 1983, at 38. Walter K. Olson is among the most forceful critics of the U.S. legal system. See WALTER K. OLSON, THE LITIGATION EXPLOSION (1991). Reviewing his book, former U.S. Supreme Court Chief Justice Warren Burger wrote:

To demonstrate that our society is drowning in litigation, one only has to look at the over-worked system of justice, the delays in trials, the clogs businessmen face in commerce and a medical profession rendered overcautious for fear of malpractice suits. The litigation explosion, which developed in barely more than a decade beginning in the 1970s, has affected us at all levels, including, as Mr. Olson notes, "the most sensitive and profound relationships of human life." The consequences of the explosion have become painfully obvious. Suits against hospitals and doctors, which went up 300-fold since the 1970s, increased doctors' medical insurance premiums more than 30-fold for some. We have more lawyers per 100,000 people than any other society in the world. We have almost three times as many lawyers per capita as Britain, with whom we share the common law system.

Warren E. Burger, *Too Many Lawyers, Too Many Suits*, N.Y. TIMES, May 12, 1991, § 7 (Book Review), at 12.

2. The American rule has long dominated the legal landscape in this country. The U.S. Supreme Court first articulated it in *Arcambel v. Wiseman*, 3 U.S. (3 Dall.) 306 (1796). The Supreme Court has repeatedly reaffirmed its prevalence, most recently in *Alyeska Pipeline Serv. Co. v. Wilderness Socy.*, 421 U.S. 240 (1975). For an overview of fee shifting and the American rule, see generally Symposium, *Attorney Fee Shifting*, LAW & CONTEMP. PROBS., Winter 1984, at 1.

3. Some have called it the "rest-of-the-world rule," as virtually every other legal system routinely awards fees to the prevailing party. See OLSON, *supra* note 1, at 329-30.

4. Noneconomic articles advocating adoption of the British Rule include Philip S. Figa, *The "American Rule" Has Outlived its Usefulness; Adopt the "English Rule,"* NATL. L.J., Oct. 20, 1986, at 13; Michael F. Maver & Wayne Stix, *The Prevailing Party Should Recover Counsel Fees*, 8 AKRON L. REV. 426 (1975); Phillip A. Middleton, *To the Victor, the Spoils: Proposal to Abandon the American Rule*, 41 MO. BAR J. 79 (1985); Mathew B. Wills & Neil Gold, *Attorneys' Fees in Litigation: Time to Discard the American Rule?*, LITIG., Spring 1978, at 31.

American rule violates the equitable principle that a party who suffers injury should be made whole.⁵ Supporters of the American rule counter that a "loser pays" rule deters risk-averse plaintiffs from pursuing meritorious claims, especially against rich defendants who can afford expensive counsel.⁶

A substantial body of literature has emerged analyzing the theoretical impact of the two rules on a litigant's decision to file a claim and settle or proceed to trial.⁷ Law-and-economics scholars such as Richard Posner and Steven Shavell concluded that switching to the British rule would lead to the counterintuitive result of lower settlement rates.⁸ Others predicted more expensive trials under a loser-pays rule.⁹ More recently, John Hause demonstrated that switching from the American to the British rule would probably lead to fewer claims and more settlements, in large part because tried cases would tend to cost more.¹⁰ The large body of literature analyzing fee shifting, however, does not explicitly consider the widely used contingency fee and its relationship to litigants' decision processes.¹¹

5. For a particularly moving argument based on personal experience, see Albert A. Ehrenzweig, *Reimbursement of Counsel Fees and the Great Society*, 54 CAL. L. REV. 792 (1966) (recounting from personal experience the impossibility of retaining counsel under the American rule for modest household moving losses and advocating adoption of the British rule).

6. For example, Ralph Nader denounced a Bush administration proposal to move partially toward the British rule, saying "corporate goliaths" would use the rule to "intimidate victims." Public Citizen press release (Aug. 13, 1991), *quoted in* Daily Rep. For Executives (BNA), Aug. 14, 1991, at A3.

7. John Gould, William Landes, Richard Posner, and Steven Shavell were important contributors to development of a decision model based on the litigants' subjective assessments of probability of success, magnitude of judgment, and estimate of legal costs. See John P. Gould, *The Economics of Legal Conflicts*, 2 J. LEGAL STUD. 279 (1973); William M. Landes, *An Economic Analysis of the Courts*, 14 J.L. & ECON. 61 (1971); Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEGAL STUD. 399 (1973); Steven Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs*, 11 J. LEGAL STUD. 55 (1982). For a good summary of the law-and-economics literature addressing this issue, see Richard D. Cooter & Daniel L. Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution*, 27 J. ECON. LITERATURE 1067 (1989). Other helpful articles include John J. Donohue III, *Opting for the British Rule, or If Posner and Shavell Can't Remember the Coase Theorem, Who Will?*, 104 HARV. L. REV. 1093 (1991); I.P.L. P'ng, *Strategic Behavior in Suit, Settlement, and Trial*, 14 BELL J. ECON. 539 (1983); Edward A. Snyder & James W. Hughes, *The English Rule for Allocating Legal Costs: Evidence Confronts Theory*, 6 J.L. ECON. & ORG. 345 (1990).

8. Richard A. Posner, *Comment on Donohue*, 22 LAW & SOC. REV. 927, 928 (1988) ("[M]aking the losing party pay the winning party's attorney's fees would reduce, not increase, the settlement rate."); Shavell, *supra* note 7, at 65 (lower settlement rates under British rule when parties' expected judgments are equal). In his well-known law-and-economics book, Judge Posner is more guarded, predicting uncertain settlement effects but higher direct litigation costs. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 539-40 (3d ed. 1986).

9. See Ronald Braeutigam et al., *An Economic Analysis of Alternative Fee Shifting Systems*, 47 J.L. & CONTEMP. PROBS. 173 (1984); John C. Hause, *Indemnity, Settlement, and Litigation, or I'll Be Suing You*, 18 J. LEGAL STUD. 157 (1989); Avery Katz, *Measuring the Demand for Litigation: Is the English Rule Really Cheaper?*, 3 J.L. ECON. & ORG. 143 (1987).

10. Hause, *supra*, note 9, at 167-68.

11. The common practice of paying one's attorney a fixed percentage of any recovery is an-

In a controversial report recommending measures to restrain litigation, the President's Council on Competitiveness (PCC) has advocated adoption of a modified British rule which would award attorney fees to the prevailing party.¹² The PCC proposal limits indemnification of the winner's attorney fees to the loser's own legal costs, thus mitigating the concern that a wealthy litigant could extort submission from an opponent by threatening to conduct a very costly legal campaign.¹³ The rule would allow judicial discretion to limit indemnification further where appropriate.¹⁴ Application of the PCC rule would be limited to lawsuits based on diversity jurisdiction in federal court.¹⁵

other anomaly of the American legal system. P.S. Atiyah, *Tort Law and the Alternatives: Some Anglo-American Comparisons*, 1987 DUKE L.J. 1002, 1017.

12. COUNCIL ON COMPETITIVENESS, *supra* note 1, at 24-25. The report was the basis for Vice President Quayle's much-publicized address to the American Bar Association in Atlanta in August, 1991.

Legislation has been introduced in Congress to implement the Council's recommendations. The relevant provisions of the House and Senate bills are identical:

SEC. 3. DIVERSITY OF CITIZENSHIP JURISDICTION; AWARD OF ATTORNEYS' FEES TO PREVAILING PARTY.

Section 1332 or title 28, United States Code, is amended by inserting after subsection (e) the following new subsection:

"(f)(1) The prevailing party in an action under this section shall be entitled to attorneys' fees only to the extent that such party prevails on any position or claim advanced during the action. Attorneys' fees under this paragraph shall be paid by the nonprevailing party but shall not exceed the amount of the attorneys' fees of the nonprevailing party with regard to such position or claim. If the nonprevailing party receives services under a contingent fee agreement, the amount of attorneys' fees under this paragraph shall not exceed the reasonable value of those services.

"(2) In order to receive attorneys' fees under paragraph (1), counsel of record in any action under this section shall maintain accurate, complete records of hours worked on the matter regardless of the fee arrangement with his or her client.

"(3) As used in this subsection, the term 'prevailing party' means a party to an action who obtains a favorable final judgment (other than by settlement), exclusive of interest, on all or a portion of the claims asserted during the action.

"(4) The court may, in its discretion, limit the fees recovered under paragraph (1) to the extent that the court finds special circumstances that make payment of such fees unjust.

"(5) This subsection shall not apply to any action removed from a State court pursuant to section 1441 of this title, or to any action in which the United States, any State, or any agency, officer, or employee of the United States or any State is a party. . . ."

H.R. 4155, 102d Cong., 2d Sess., *reprinted in* 138 CONG. REC. H259, H260 (daily ed. Feb. 4, 1992); S. 2180, 102d Cong., 2d Sess., *reprinted in* 138 CONG. REC. S910, S911 (daily ed. Feb. 4, 1992).

13. This clearly undesirable predicament is apparently not a significant problem under the pure British rule as commonly practiced. After final judgment, the parties appear before a taxmaster attached to the court whose decision is seldom appealed. The taxmaster often limits indemnification after considering the characteristics of the controversy and parties involved, especially if the prevailing party demands unreasonable legal fees. Atiyah, *supra* note 11, at 1023; Mavor & Stix, *supra* note 4, at 430-31. *See generally* Symposium, *supra* note 2. In Ontario, Canada, such considerations frequently result in the prevailing party's recovering only one half of legal expenses. Interview with Ronald Walker, Practicing Toronto Attorney, in Ann Arbor, Mich. (April 12, 1992).

14. COUNCIL ON COMPETITIVENESS, *supra* note 1, at 24.

15. *See* 28 U.S.C. § 1332 (1988). The rule would not affect federal subject matter jurisdiction suits, such as civil rights and environmental protection statutes. The diversity plaintiff would be free to avoid the fee-shifting rule by pursuing his claim in state court. The PCC may have restricted application of its proposed rule as a political compromise necessary for passage; the

This Note seeks to predict the direction and magnitude of the change in settlement frequency under the three fee-shifting rules: American, British, and the British rule as modified by the PCC. Part I analyzes the proposed rule using the theoretical model of litigation and settlement developed by Hause. Part II examines the impact of fee shifting when the plaintiff's lawyer receives reimbursement via a contingency fee. Analysis of indemnification in a contingency fee context raises several policy issues which section II.A addresses. Section II.B discusses the terms and assumptions made in adjusting Hause's model to reflect the standard contingency fee arrangement, and section II.C proceeds with an economic analysis to discern the impact of the three rules on settlement. This Note concludes that regardless of how the plaintiff's lawyer is compensated, a modified British rule will probably result in more settlements than the American rule and will moderate the likelihood of greatly increased trial expenses sometimes predicted under a pure British rule.

I. THE BASIC SETTLEMENT MODEL

This Part examines the likelihood of settlement under the American, British, and PCC rules. The traditional model of litigation and settlement behavior is first reviewed and adjusted to reflect the proposed PCC rule. After comparing the likelihood of settlement under the three fee-shifting rules, the analysis is repeated incorporating Hause's important modifications into the litigant decision model. This Part concludes with a discussion of the implications of adopting a modified British rule absent contingency fee considerations.

The prevailing economic model of the claim, settlement, and litigation decision assumes that a plaintiff will file a claim when profitable and that parties will settle when such compromise is in their mutual best interests. Let P be the plaintiff's subjective probability that the plaintiff will prevail if his suit proceeds to trial,¹⁶ C be the plaintiff's direct legal costs of going to trial,¹⁷ and J be the judgment he expects to receive if he prevails. The plaintiff's expected benefit F of pursuing his case to trial under the American rule is

$$F_A = PJ - C. \quad (1)$$

Let the defendant's expected probability that the *plaintiff* will prevail

proposal's limited reach mitigates the worst fears of skeptics in the American Bar Association and Congress.

16. To facilitate exposition, the hypothetical plaintiff will assume the masculine pronoun and his variables will be uppercase. The defendant will assume the feminine pronoun with lowercase variables.

17. The economic analysis ignores the indirect costs of trial, e.g., psychic costs, opportunity costs due to time spent away from normal activities, and bad publicity. These costs, often substantial, are obviously difficult to quantify. Affected litigants will seek settlement sooner than the economic model suggests.

be p , her expected judgment amount if plaintiff prevails be j , and her own estimated costs of trial be c . Under the American rule, the defendant's expected cost, f , is

$$f_A = pj + c. \quad (2)$$

Under a "pure" British rule, the successful plaintiff expects to recover not only a judgment, J , but also his legal costs. His expected gain, however, is tempered by the probability that he will lose $(1 - P)$ times the defendant's legal costs incurred via indemnification:

$$F_B = P(J + C) - (1 - P)c - C. \quad (3)$$

Similarly, the defendant's expected costs under the British rule are

$$f_B = p(j + C) - (1 - p)c + c. \quad (4)$$

Finally, the PCC rule modifies the respective expectations held by the plaintiff and defendant under the British Rule. The prevailing party receives indemnification only to the extent of the loser's own legal costs. Thus, the successful plaintiff will recover either C or c , whichever is less, and if unsuccessful will pay out the lesser of C or c :

$$F_M = P(J + \min(C, c)) - (1 - P)(\min(C, c)) - C. \quad (5)$$

Analogous limits apply to the defendant's expected costs, f :

$$f_M = p(j + \min(C, c)) - (1 - p)(\min(C, c)) + c. \quad (6)$$

If the plaintiff's expected gain from going to trial, F , is less than (or equal to) the defendant's expected costs of going to trial, f , settlement is in both parties' interests. In such a case, avoiding legal costs maximizes expected wealth.¹⁸ The condition for settlement under the American rule is thus

$$PJ - C \leq pj + c$$

or alternatively,

$$\begin{aligned} PJ - pj &\leq C + c \\ \text{or} \\ 0 &\leq pj - PJ + C + c. \end{aligned} \quad (7)$$

Equation (7) states that settlement will occur if the difference in judgments expected by the plaintiff and the defendant is less than the combined anticipated costs of going to trial.¹⁹

18. When $F = \$300$ and $f = \$500$, the settlement range lies between these figures. Both parties benefit by settling out of court for \$400. If $F > f$ no settlement will occur. This section of the Note assumes that both parties are rational economic wealth maximizers and are not risk-averse. This standard assumption, although admittedly unrealistic, is informally relaxed when the relationship between the applicable rule and the parties' assessment of plaintiff's success is discussed. See *infra* text accompanying note 24.

19. Legal costs of settlement are transaction costs that will also affect the settlement equa-

The settlement conditions for the other rules are rearranged similarly. Under the British rule:

$$0 \leq pj - PJ - (P - p)(C + c) + C + c \quad (8)$$

and PCC rule:

$$0 \leq pj - PJ - (P - p)(2\min(C, c)) + C + c. \quad (9)$$

A comparison of equations (7) and (8) reveals that the settlement condition under the British rule will be satisfied less often than the condition under the American rule so long as the parties are optimistic, i.e., when $P > p$,²⁰ and the variables remain independent of the fee-shifting rule, i.e., $P_A = P_B$, $C_A = C_B$, etc. The right hand side (RHS) of equation (8) will always be less than the RHS of (7) given these assumptions. Thus under the British rule, the range of mutually acceptable settlement values decreases. This occurs because the stakes under indemnification are higher than under the American rule — the winner is better off and the loser is worse off. This result led Posner and Shavell to conclude that the British rule would lead to fewer settlements.²¹

Settlement under the PCC rule (9) is readily compared to the British rule (8). Clearly, the RHS of equation (9) will always equal or exceed that of equation (8), indicating more settlements under the PCC rule. The middle term under the British rule condition will always be more negative (because $P - p$ is positive by assumption) than the middle term of the PCC condition so long as $C \neq c$. Because the settlement condition is harder to satisfy under the British rule, fewer settlements should occur under that rule than the PCC rule.

Hause's most important contribution to the above analysis shows that two assumptions implicit in it are seriously flawed. First, because the stakes are higher under the British and PCC rules, litigants will tend to spend more heavily on legal services to increase their probability of winning. Legal expenditures are effectively discounted by a party's assessment of personal success. Under the British rule, a plaintiff ninety percent convinced of prevailing at trial who spends one dollar on legal work expects to recover ninety cents of that dollar. Given increased stakes and discounted legal costs, parties will natu-

tion. Settlement costs will remain constant, however, regardless of the fee-shifting rule adopted. They are ignored in the text because they fall out upon comparison of the different fee-shifting rules. Hause, *supra* note 9, at 166-67.

20. Optimistic in this context means the plaintiff places a higher probability on his success and the defendant places a lower probability on plaintiff's success. See POSNER, *supra* note 8, at 524. Thus, the parties are optimistic if the plaintiff thinks he has a 30% chance of winning and the defendant thinks the plaintiff's odds are only 20%. If the parties are pessimistic, i.e., $P < p$, the settlement condition will virtually always be satisfied when J and j are approximately equal.

21. See *supra* note 8.

rally spend more to influence the outcome.²² A proof of this proposition may be found in the appendix. The PCC rule also increases the stakes of litigation, but more modestly than the British rule due to indemnification limits. It follows that the parties' legal costs under the PCC rule will also tend to be greater than under the American rule but less than those under the pure British rule.

The second flawed assumption is that the parties' expectations of success, P and p , remain constant under differing legal rules. As the stakes change, the parties very likely will become more concerned about precise predictions of success.²³ The costs of false optimism are higher under an indemnity system. Moreover, indemnity will invariably intimidate some risk-averse parties.²⁴ These litigants will tend to be more conservative in their estimates of the likelihood of success to compensate for greater exposure to fee liability. Both of these effects will bring the parties' estimates of P and p closer together under both the British and PCC rules — the "probability gap" will converge.

To analyze correctly the effect of the fee-shifting rule on settlement, these increased legal costs and converging probabilities must be considered explicitly. Returning to the equations defining the settlement conditions, implicitly assume that the expected judgment amount J equals j ²⁵ and assume further that J and j are independent of the fee-shifting rule.²⁶ The settlement conditions become:

$$P_A J - p_A j \leq C_A + c_A \quad (\text{American})$$

$$P_B J - p_B j \leq (1 + p_B - P_B) (C_B + c_B) \quad (\text{British})$$

$$P_M J - p_M j \leq (p_M - P_M) (2\min(C_M, c_M)) + (C_M + c_M). \quad (\text{PCC})$$

22. Numerous commentators have reached this conclusion. The appendix reproduces the methodology used by Hause. See *supra* note 9, at 165-66. For wholly different theoretical approaches that reach the same conclusion, see Braeutigam et al., *supra* note 9; Katz, *supra* note 9.

23. See POSNER, *supra* note 8, at 539; Katz, *supra* note 9, at 158.

24. See, e.g., POSNER, *supra* note 8, at 539.

25. The nomenclature differentiating the two parties' expectations is retained to illustrate the behavior of the settlement model. Commentators nearly always assume $J = j$. See, e.g., Shavell, *supra* note 7, at 65. This simplifying assumption is most likely true in straightforward contract disputes; it may be less true in specific claims involving highly variable nonmonetary injuries. In any event, it is likely true in the aggregate of civil suits.

26. In economic terms, we are assuming J and j are exogenous, i.e., the magnitude of the judgment is not affected by changes in other terms in the equation. Hause claims that this assumption does not alter the analysis. Hause, *supra* note 9, at 168 & n.13. A more objectionable assumption implicit in the following analysis is that c is unaffected by changes in C . One would expect that a large increase in plaintiff's legal costs would prompt some response from defendant's counsel. Hersch pursues this analysis and concludes that, although codependence of the parties' legal costs probably softens Hause's predictions, Hause's conclusions remain valid. Philip L. Hersch, *Indemnity, Settlement, and Litigation: Comment and Extension*, 19 J. LEGAL STUD. 235, 240 & n.11 (1990).

Rearrangement of the equations facilitates comparison:

$$0 \leq (p_A j - P_A J) + (C_A + c_A) \quad (10)$$

$$0 \leq (p_B j - P_B J) - (P_B - p_B)(C_B + c_B) + (C_B + c_B) \quad (11)$$

$$0 \leq (p_M j - P_M J) - (P_M - p_M)(2\min(C_M, c_M)) + (C_M + c_M). \quad (12)$$

The greater the magnitude of the RHS of the equations, the more easily the settlement condition is satisfied. As stated above and proven in the appendix, litigation costs will generally be higher under the British rule, i.e., $C_B c_B > C_A c_A$. The magnitude of the increase is unclear, although both Hause and Katz have predicted the British rule could easily double the cost of litigation.²⁷ Thus the last term of the RHS under the American rule will be substantially smaller than the corresponding term under the British rule. Higher predictions of legal expenses under the British rule will clearly encourage the parties to avoid these costs through settlement.

Higher stakes under the PCC rule will also drive up litigation costs, C_M ; however, stakes and costs will always be highest under the British rule. The term $(C_B + c_B)$ will be largest, followed by $(C_M + c_M)$ and $(C_A + c_A)$. Thus legal costs should promote settlement most often under the British rule, followed by the PCC rule and the American rule.

Next, consider the first term of the American rule and the corresponding terms below. This term represents the difference between the parties' expectations of trial outcome. Although facially identical under the three rules, the term is greatly affected by converging probability estimates discussed above.²⁸ The difference between the parties' estimates of the plaintiff's success ($p - P$) will shrink under indemnification as the litigants become more concerned with accuracy and, if risk-averse, less optimistic. The first term will accordingly be largest and least favorable to settlements under the American rule, and smallest and most favorable under the British rule. The PCC proposal, with less than full indemnity and medial stakes, will again occupy an intermediate position.

Both terms just examined would thus predict higher rates of settlement under the British and PCC rules than the American rule. The pivotal term is $(P_B - p_B)(C_B + c_B)$ in the British rule (11), and the parallel PCC term in (12). These terms, absent from the American rule, will be negative and will detract from the probability of settlement. The probability contraction discussed above directly affects this term. Although $P_B > p_B$ by assumption, it would probably be uncom-

27. Hause, *supra* note 9, at 175 ("[H]igh levels of indemnity may induce excessive trial expenditures."); Katz, *supra* note 9, at 171 ("[The] English rule could result in an increase in [litigation] expenditure of over 100 percent in the typical case.").

28. See *supra* notes 23-24 and accompanying text.

mon for $P_B - p_B$ to be "large" (relative to 1) due to the tendency of parties' estimates to converge as the stakes increase.²⁹ Hause finds it "intuitively plausible" that this middle term will not usually be so powerful as to overcome the effects of the British rule on the first and last terms.³⁰ He thus concludes that the British rule will result in more settlement than the American rule. If his conclusion is correct, then the PCC rule will also result in more settlement than the American rule. The indemnifying limitation under the PCC rule sharply restricts the magnitude of this term; it will normally be substantially less negative than under the British rule and consequently have less of a dampening effect on settlement.

By effectively discounting expected legal costs of trial, the British and PCC rules introduce a new term into their settlement conditions that discourages settlement. However, increased legal costs and converging probability estimates almost certainly affect settlement conditions under indemnification rules. Higher legal costs under indemnification will induce many optimistic litigants to avoid these costs by settling. Allowing indemnification will also tend to narrow the probability gap between the parties' predictions of the plaintiff's success and thus further encourage settlement. The above analysis predicts a net increase in settlement under both the British and PCC rules when compared to settlement under the American rule. However, because the PCC rule limits indemnification, settlement rates will not be as high as they would be under a pure loser-pays rule.

II. FEE SHIFTING IN A CONTINGENCY FEE CONTEXT

The contingency fee dominates most tort litigation in the United States today.³¹ Under a contingency-fee arrangement, the attorney contracts with the plaintiff for a portion, typically one third, of the amount collected from a trial judgment or through settlement. Sometimes the plaintiff's attorney will be rewarded far in excess of the time and effort invested in the case, while at other times he will receive nothing. Over time and many cases, an attorney will presumably achieve a market rate of return in such contingency cases.³²

Proponents claim the contingency-fee arrangement offers three im-

29. Hause, *supra* note 9, at 167; see also Hersch, *supra* note 26, at 235. But see John J. Donohue, *The Effects of Fee Shifting on the Settlement Rate: Theoretical Observations on Costs, Conflicts, and Contingency Fees*, LAW & CONTEMP. PROBS., Summer 1991, at 195, 203-06 (arguing that, if total litigation cost-to-damages ratio remains constant under the changing rules, $P_B - p_B$ must be fairly large).

30. Hause, *supra* note 9, at 167.

31. The Federal Trade Commission reports that 97% of lawyers accept personal injury cases only on a contingency basis. See L. Gordon Crovitz, *Contingency Fees and the Common Good*, WALL ST. J., July 21, 1989, at A14.

32. Thomas J. Miceli & Kathleen Segerson, *Contingent Fees For Lawyers: The Impact on Litigation and Accident Prevention*, 20 J. LEG. STUD. 381, 384-85 (1991).

portant advantages.³³ First, it enables plaintiffs who might not be able to afford an hourly rate attorney the opportunity to pursue a claim on an attorney's "borrowed time." Second, because the outcome of a lawsuit is inherently uncertain, plaintiffs are able to shift their economic risk to the attorney who can spread the risk over his entire caseload. Finally, the contingent fee aligns the interests of the principal/plaintiff with those of the agent/attorney. Critics of the contingent fee system counter that it produces high fees, encourages excessive litigation,³⁴ and creates incentives for lawyers to accept settlement offers when it is contrary to their clients' best interests.³⁵

The nature of a fee-shifting rule in a contingency-fee context largely depends on the resolution of three questions: Should the plaintiff or his attorney indemnify the winning defendant her attorney's fees; how should the contingency-fee lawyer's costs be assessed; and from whose perspective, plaintiff's or his attorney's, should the likelihood of settlement be determined? These questions raise important policy concerns that provide insight into the theoretical economic analysis. This Part begins by discussing these policy issues with minimal economic analysis; it proposes a set of rules that allocates the costs, risks, and benefits between the legal actors. Section II.B uses the economic tools developed in Part I to construct the parties' expected benefit and cost equations under the American, British, and PCC rules. Using these results, section II.C analyzes four different sets of settlement equations under the different fee-shifting rules, representing the four most likely conditions under which indemnification would operate.

33. See *id.* at 381; Terry Thomason, *Are Attorneys Paid What They're Worth? Contingent Fees and the Settlement Process*, 20 J. LEG. STUD. 187, 187-88 (1991).

34. The contingency fee allegedly acts as a de facto "sales commission" in the recruitment and representation of plaintiffs. For example, firms specializing in representing tort plaintiffs commonly spend large amounts in television advertising. Lawyers spent over \$102 million in television advertising in 1991. Telephone Interview with Ronni Faust, Television Bureau of Advertising (Mar. 23, 1992) (data supplied by Arbitron Media Watch Service of top 75 markets); Charlotte Ahern, *Legal Eagles Make a Case for TV Advertising Boon*, ADVERTISING AGE 110 (Oct. 19, 1987) (reporting \$47 million in lawyer advertising on television in 1986). Contingency-fee plaintiffs by definition have nothing to lose other than indirect burdens such as psychic costs. Cf. *supra* note 17. Heavy solicitation, which typically emphasizes the absence of monetary risk to the client, certainly encourages individuals to seek legal redress. Even nonmeritorious suits will settle given sufficiently high defense estimates of direct legal fees and indirect costs of trial. *Id.* Miceli and Segerson acknowledge that, if an accident has occurred, the contingent fee system encourages more suits to be filed than an hourly fee system. Nevertheless, they argue that the deterrent effect of such lawsuits may elicit greater care by potential injurers and thus reduce the overall number of lawsuits. Miceli & Segerson, *supra* note 32, at 388-91.

35. For an economic analysis of the divergent interests, see equations (16) and (17) *infra* and accompanying text. See also sources cited *infra* note 47. For an unrestrained critique of the influence of the attorney-agent in settlement and trial, supported by innumerable anecdotes, see OLSON, *supra* note 1, at 51-66 (ch. 3: "Role Reversal: How Lawyers Took Charge").

A. Policy Questions

This section examines three issues that immediately arise when fee-shifting is implemented in a contingency fee legal environment. The first is whether the losing plaintiff or his attorney should bear legal responsibility to pay the winner's attorney fees. Second, there are several possible definitions of plaintiff's legal costs. Fee shifting requires a determination of which definition should be used under varying circumstances. Finally, Part I compared settlement conditions from the perspective of the underlying parties. Under a contingency fee arrangement, however, the plaintiff's lawyer has incentives to settle that usually diverge from the client's interests.³⁶ The choice of whose perspective to adopt, the plaintiff's or his attorney's, has a large impact when comparing the likelihood of settlement under different fee-shifting rules.

The discussion below assumes (1) that a constant percentage, β , of the plaintiff's proceeds flow to the contingency-fee attorney,³⁷ and (2) that this percentage applies only to the amount received in judgment or settlement; the contingency-fee attorney would not receive one third of any attorney fee received from the indemnifying party. Mathematically,

$$\text{compensation} = \beta J \text{ not } \beta(J + \text{attorney fees}).$$

A rule allowing enhanced attorney fee recovery, β times the sum of judgment plus fees, has little merit. If attorneys require higher compensation to cover increased risks arising under a fee-shifting rule, they may adjust β to remain viable and competitive. Furthermore, one of the primary purposes of attorney fee indemnification is to ensure that the injured plaintiff receives full compensation.³⁸ Taking one third of the total money changing hands will obviously dilute the plaintiff's final recovery.³⁹ Finally, augmenting the prevailing attorney's fees logically suggests increasing the indemnification provided by the defendant to keep the plaintiff whole. Once started, such a cycle continues *ad infinitum*.

Preliminarily, the legal system must decide whether the plaintiff or his attorney should be responsible for indemnifying the prevailing defendant. Several policy reasons exist for placing this risk on the plain-

36. The analysis assumes that the defendant will continue to pay her attorney on an hourly basis; thus, the question of proper perspective in Part II only involves the plaintiff.

37. Typically, the contingency percentage is one third of all proceeds, although it reportedly reaches 50% in some cases. OLSON, *supra* note 1, at 47. The assumption of a constant percentage reflects typical practice, although some attorneys vary the percentage depending on the stage of litigation, e.g., 30% of settlement proceeds and 50% of trial judgment proceeds. See Donohue, *supra* note 29, at 210 n.55.

38. See, e.g., Ehrenzweig, *supra* note 5.

39. $\frac{J}{3}$ is always less than $\frac{(J + \text{fee})}{3}$.

tiff's attorney. First, the attorney is usually better equipped to assess the risks and benefits of contemplated legal actions and can more easily pursue the information necessary to make an informed decision. In a typical case, the plaintiff has little knowledge of the law, likely defense costs, or the likelihood of trial success. With these advantages over the client, the attorney is arguably better positioned both to make the decision and to bear the ensuing risk of loss. Second, experienced trial lawyers are probably less risk averse — more "rational" in economic terms — than their clients. If so, claims that ought to be pursued when considered from a purely objective economic viewpoint will less likely be abandoned due to an "irrational" fear of losing. Third, juries may be more objective in assessing the merits of cases when the attorney bears indemnification responsibility. If a jury knows that a verdict for the defendant will result in hardship for the plaintiff, the jury may hesitate to "punish" the plaintiff by imposing the defendant's legal fees on him. The jury might be less inclined to let sympathy dictate its findings if it knew the plaintiff's attorney, and not the plaintiff, would bear the cost of defeat.⁴⁰

Other arguments for charging the attorney with indemnification parallel the justifications for allowing contingency fee arrangements in the first place.⁴¹ Plaintiffs as a class are often of modest means; bearing the risk of indemnification clearly will dissuade some deserving plaintiffs from pursuing meritorious claims. The attorney can absorb the added risk of indemnification by increasing fees, thus spreading the implicit cost over the attorney's many clients. The one-time plaintiff cannot diversify risk in this manner.

Indemnification shouldered by the attorney, however, has several serious policy drawbacks arising from the fundamental agency relationship between the attorney and the client. The attorney's role is mainly to serve as *counsel* — to offer opinions and advice and then follow the directions of his client.⁴² Placing indemnification responsibility on the agent further magnifies the attorney's role in a dispute which is supposedly a contest between the plaintiff and the defendant. This is troubling, both ideologically and practicably.

As a philosophical matter, absolving the plaintiff-principal of responsibility for his decisions turns the agency relationship on its head: the agent becomes responsible for decisions ostensibly made by the principal. This seems manifestly unfair to the attorney-agent. The attorney's pretrial responsibility, at least as traditionally defined, is to

40. Cf. Angel Gomez III & Carla S. Harwitt, *Jury Empathy Aids Counsel in Company's Defense*, NATL. L.J., May 20, 1991, at 56 (exploring jury empathy and advocacy).

41. See *supra* text accompanying notes 33-35.

42. "A lawyer shall abide by a client's decisions concerning the objectives of representation . . . and shall consult with the client as to the means by which they are to be pursued. A lawyer shall abide by a client's decision whether to accept an offer of settlement of a matter." MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.2(a) (1984).

advise and take subsequent action at the direction of his client. The indemnifying attorney who reluctantly goes to trial pays a high price for following his client's orders. The punitive aspect of such risk allocation is the equivalent of shooting the messenger who bears bad news.⁴³ Furthermore, elevating the attorney's role in the proceedings necessarily diminishes the client's role and undermines respect for the plaintiff and his claim. Under the current system, the contingency-fee plaintiff bears no responsibility for any legal costs. Not coincidentally, plaintiffs and their grievances are commonly held in low esteem by defendants, the defense bar, and increasingly by the general public.⁴⁴ Sheltering plaintiffs from responsibility for their decisions may also diminish respect for the legal system generally.⁴⁵ These effects subvert essential principles embodied in Western liberal traditions of respect for the individual and individual responsibility for one's decisions.⁴⁶

The most compelling reason to reject placing indemnification responsibility on the attorney is far more utilitarian. The contingency-fee attorney already operates under the substantial risk that he will lose and not be paid for his work. This risk seriously misaligns the settlement incentives of the attorney and his client, leading to substantially lower plaintiff recoveries.⁴⁷ An added attorney burden of indemnification would intensify the conflict and exacerbate its effect of eroding plaintiff recoveries.

43. Cf. WILLIAM SHAKESPEARE, *ANTONY AND CLEOPATRA* (As a messenger reports to Cleopatra the unwelcome news of her lover's marriage to Octavia):

Messenger: "He's married, madam."

Cleopatra: "Rogue, thou hast liv'd too long." (*Draw a knife.*)

Messenger: "Nay then I'll run. What mean you madam? I have made no fault." (*Exit.*)
Id. act 2, sc. 5.

44. See Lance Morrow, *A Nation of Fingerpointers*, TIME, Aug. 12, 1991, at 14 (cover story disparaging those who sue rather than recognizing their own responsibility).

45. See, e.g., Atiyah, *supra* note 11, at 1002-03 (Professor of English Law at Oxford University criticizing American legal system).

46. See, e.g., JOHN STUART MILL, ON LIBERTY 53 (Elizabeth Rapaport ed., Hackett 1978) (London, Parker & Son 1859) ("[I]f [an individual] refrains from molesting others in what concerns them, and merely acts according to his own inclination and judgement in things which concern himself, . . . he should be allowed, without molestation, to carry his opinions into practice at his own cost.").

47. The attorney has a personal incentive to settle the case early to avoid litigation costs and get paid his contingency percentage; the client may well expect to recover more if the case proceeds to trial. See equations (16) and (17) *infra* and accompanying text. This misalignment has attracted considerable attention in the law-and-economics literature. See, e.g., Geoffrey P. Miller, *Some Agency Problems in Settlement*, 16 J. LEGAL STUD. 189 (1987) (contingent fee attorneys will accept settlements that are suboptimal from the perspective of the claimant); Andrew Rosenfield, *An Empirical Test of Class-Action Settlement*, 5 J. LEGAL STUD. 113 (1976) (empirical evidence that class-action attorneys maximize their fees at the expense of plaintiff awards); Murray L. Schwartz & Daniel J.B. Mitchell, *An Economic Analysis of the Contingent Fee in Personal-Injury Litigation*, 22 STAN. L. REV. 1125 (1970) (contingent fee contracts create conflict of interest between attorneys and their clients); Thomason, *supra* note 33, at 221 (empirical evidence that worker compensation claimants who retain contingent-fee legal counsel may expect to receive smaller gross awards, before legal fees are deducted, than awards received by claimants who forgo legal advice).

On balance, placing the risk of defendant indemnification on the plaintiff better serves the plaintiff's interests. The contingency-fee attorney's superior ability to estimate probabilities accurately and to absorb risk is unfortunately far less useful to the plaintiff given the conflict of interest in settling created by a contingency fee system. The benefit of receiving a full, undiluted judgment if successful mitigates the potential cost that indemnification places on the plaintiff. The risk of indemnification will undoubtedly deter some plaintiffs from pursuing borderline claims, but attorneys burdened with indemnification would reject many such claims anyway. Finally, some highly risk-averse clients might fail to seek recovery for meritorious claims. In such cases, the contingency-fee attorney and plaintiff should be allowed to negotiate an arrangement whereby the attorney agrees to indemnify if the defendant prevails.⁴⁸ Thus, even highly risk-averse claimants may partially recover with competent counsel.

The second question preliminary to the mathematical analysis relates to the calculation of legal costs to be indemnified. In Part I, these costs were established by the actual costs billed by the parties' respective counsel. Under a contingency fee, there is no such billing of the plaintiff. The plaintiff's legal costs may be defined in one of three ways: (1) β (e.g., one third) times the amount of settlement or judgment if successful at trial (denoted βJ); (2) a reasonable amount of compensation at fair market value based on the attorney's work (C_{fmv});⁴⁹ or (3) the internal cost — the cost of spending time on the case as subjectively felt by the plaintiff's attorney (C_{int}). C_{int} would normally be lower than C_{fmv} because C_{fmv} includes the attorney's profit markup.⁵⁰

Suppose a plaintiff prevails at trial and recovers a substantial judgment. Which measure of cost should be charged to the defendant as proper indemnification? If the attorney has contracted with the plain-

48. This is simply an embodiment of the Coase theorem. See Ronald Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960) (parties will bargain around the operative legal rule to reach the identical, efficient outcome, provided there are no transaction costs and no wealth effects associated with the assignment of the legal entitlement). Law-and-economics scholars strongly defend the Coase theorem. For a collection of articles attacking a Coase critic, see Forum, *A Response and a Reply to Whether Pigs Can Fly*, 38 WAYNE L. REV. 1 (1991) (responding to Daniel Q. Posin, *The Coase Theorem: If Pigs Could Fly*, 37 WAYNE L. REV. 89 (1990)). Until recently, the Coase theorem was ignored in the fee-shifting literature. Donohue, *supra* note 7, 1094.

49. C_{fmv} would roughly correspond to the "lodestar" determination of appropriately shifted fees when a statute explicitly provides for such indemnification, i.e., reasonable hours times a reasonable rate. See *Hensley v. Eckerhart*, 461 U.S. 424, 433 (1983) (statutory fee-shifting case under the Civil Rights Attorneys' Fees Awards Act of 1976 (codified at 42 U.S.C. § 1988 (1988))). For a review of criticism directed at the lodestar method, see Charles Silver, *Unloading the Lodestar: Toward a New Fee Award Procedure*, 70 TEXAS L. REV. 865 (1992) (proposing a new contract-based approach to simulate the free market).

50. This Note does not address the best method for ensuring precise determinations of C_{fmv} and C_{int} . Presumably these costs are self-reported by the plaintiff's attorney. See *infra* note 65 for a discussion of monitoring these costs.

tiff to receive βJ , and the defendant pays the plaintiff's attorney less than βJ , the plaintiff must subtract the difference from his recovery to satisfy his contingency-fee contract.⁵¹ Paying the attorney C_{int} is easily rejected as too low; the defendant should at least indemnify C_{fmv} . But should the defendant pay the full βJ ? Such a requirement seems unfair if βJ is very large relative to C_{fmv} . However, paying any less than βJ would deny the plaintiff full recovery.

Federal courts have struggled with this definitional issue in cases where a contingency-fee plaintiff prevails under various federal statutes which authorize fee shifting.⁵² The Supreme Court recently rejected the occasional judicial practice of awarding attorney's fees greater than the fair market value of the prevailing attorney's services.⁵³ However, the great majority of statutory fee-shifting cases appear to involve plaintiffs who prevail with only nominal damages or equitable relief or plaintiffs who have not contracted to pay their lawyers a predetermined contingency percentage.⁵⁴ In such cases, the defendant, not the plaintiff, pays the above-market compensation.

This Note assumes that when βJ exceeds C_{fmv} the defendant will indemnify at the higher amount, with the important qualifier that β must be reasonable as compared to similar cases tried under the Amer-

51. This section discusses the question in general terms; limited indemnification under the PCC rule highlights the issue in a more particular context. See *infra* section II.B.3 (expected benefits and costs under the PCC rule).

52. See, e.g., Copyright Act of 1976, § 505, 17 U.S.C. § 505 (1988); Civil Rights Attorneys' Fees Awards Act of 1976, § 2, 42 U.S.C. § 1988 (1988); Clean Air Amendments of 1970, § 304(d), 42 U.S.C. § 7604(d) (1988). Note that all of these are one-way statutes. Compensating the winning attorney at a greater rate than C_{fmv} under such statutes, because βJ is higher, is termed "contingency enhanced" recovery. See, e.g., *Pennsylvania v. Delaware Valley Citizens' Council for Clean Air*, 483 U.S. 711, 720, 726 (1987) (plurality opinion).

This Note does not address the impact of judicially imposed fee-shifting sanctions available under rule 11 (claims pursued in bad faith) or rule 68 (party rejecting settlement offer that was more favorable than eventual judgment pays opposing party's costs incurred after making the offer). FED. R. CIV. P. 11, 68.

53. *City of Burlington v. Dague*, 60 U.S.L.W. 4717 (U.S. June 23, 1992) (No. 91-810).

54. The situation where the plaintiff recovers only nominal damages is considered below. See *supra* text accompanying note 59.

Neither *City of Burlington* nor its Supreme Court predecessor, *Pennsylvania v. Delaware Valley Citizens' Council for Clean Air*, 483 U.S. 711 (1987), involved enhanced attorney fee awards based on the plaintiff's obligation to pay his attorney a percentage of his recovery. See also, e.g., *King v. Palmer*, 950 F.2d 771 (D.C. Cir. 1991) (en banc 7-4 decision). Instead, these disputes centered on whether a court may enhance attorney fees beyond the fair market value of legal services to compensate for risk irrespective of any binding contingency arrangement with the client. At one point, the *King* opinion cites 17 circuit court cases addressing statutory recovery of attorney's fees in excess of fair market value. 950 F.2d at 776. Only one of these 17 cited cases, *Craig v. Secretary, Dept. of Health and Human Servs.*, 864 F.2d 324 (4th Cir. 1989), involved a request for enhanced legal fees based on the existence of a contingency percentage contract between the plaintiff and his lawyer. See 864 F.2d at 326. Contrary to the circumstances presented in most adjudicated disputes, this Part assumes that the plaintiff has contracted to pay his lawyer a predetermined contingency percentage. See *supra* text accompanying note 37.

ican rule.⁵⁵ This assumption seems sound for three reasons.⁵⁶ First, unlike the one-way federal fee-shifting statutes that have caused such judicial angst, the British and PCC rules are neutral in their application. The potential for a higher recovery, βJ versus C_{fmy} , thus seems more fair in light of the new indemnification risk borne by the plaintiff under these rules.

Second, plaintiffs and attorneys are free to negotiate the contingency percentage, βJ , for cases of a given class and region. If one assumes a competitive market among attorneys and effective bargaining between plaintiffs and these attorneys, βJ represents fair compensation based on perceived potential recovery and risk. Limiting attorney recovery to what is "reasonable" on a case-by-case basis is a purely post hoc judicial determination of the unknown risks and rewards that confronted the attorney at the outset of the case.⁵⁷

Finally, limits on indemnification as prescribed by the PCC rule would essentially eliminate this thorny problem. When βJ is very large, the PCC rule will limit recovery to the defendant's legal costs, c ; thus, the defendant will probably pay βJ unless indemnification is circumscribed by operation of the PCC rule. For all of these reasons, the economic model will assume the defendant indemnifies at the rate βJ .⁵⁸

Now suppose that the plaintiff prevails at trial but recovers only nominal damages.⁵⁹ Should the defendant still be charged βJ ? In this case the contingency fee arrangement clearly hurts the prevailing attorney. If the attorney had billed on an hourly basis, presumably the defendant would reimburse him fully. Because the scheme "overcharges" the defendant in the example above, "undercharging" her in this case on grounds of reciprocity is arguably fair. Considering the interests of the contingency-fee attorney in isolation, the reciprocity argument is persuasive. Recovering a nominal amount is part of

55. Without a reasonableness requirement, a plaintiff's attorney litigating under an indemnification rule would have every incentive to set β at 90% or higher.

56. These three reasons are hardly exhaustive; however, they seem persuasive in the context of this Note's comparative economic analysis. For a more thorough treatment of the issue, see sources cited *supra* note 53.

57. Admittedly, the court must address the reasonableness of the contingency fee percentage, β ; however, this percentage is not set by perceived difficulty of the case but is usually fairly standardized by case type and by region. See OLSON, *supra* note 1, at 47 ("going rate" seldom undercut even when success seems virtually assured). Determining β should present far less difficulty than a detailed examination of reasonable fees for an individual case.

58. Pedagogical considerations are also implicated. Assuming a lesser recovery under the British rule would greatly impair comparison between that rule and the PCC rule in the settlement equations in section II.C. This comparison, one of the primary aims of this Note, is much easier to illustrate when consistency is maintained between the expectation equations under the different fee-shifting rules.

59. "Nominal" damages would encompass declaratory judgments and inconsequential damages. As the term is used here, it would also include any award which compensates the plaintiff's lawyer less than the fair market value of his legal services.

the risk of accepting a contingency-fee case; the attorney is free to negotiate for the appropriate β to compensate for this possibility.

However, one of the primary reasons given for establishing a fee-shifting rule is to enable plaintiffs to recover when pursuing small but meritorious lawsuits.⁶⁰ The American rule and the contingency fee system combine to make such claims unattractive for both claimant and attorney.⁶¹ Indeed, the legal system effectively denies legal redress to plaintiffs pursuing small damages and declaratory judgments because legal fees eclipse their claims. Although a fee-shifting rule would help plaintiffs who engage hourly-rate attorneys, contingency-fee attorneys would reject similar cases if recovery were limited to βJ . Yet many risk-averse plaintiffs will prefer attorneys who are willing to shoulder all the risks of losing.⁶² Because these situations are probably quite common,⁶³ the fee-shifting rule should allow prevailing attorneys in such cases to recover a reasonable rate for their work: C_{fmv} .⁶⁴

Now suppose the plaintiff or his attorney must indemnify the prevailing defendant for her legal fees. Under the pure British rule, the plaintiff's costs are irrelevant in determining the amount of indemnification; however, under the modified or PCC rule, the plaintiff's own costs limit his obligations as the losing party. It is necessary to decide which cost measure should be used to limit fee indemnification in this case.

Here, βJ is undetermined and thus not useful. The indemnification limit should thus be either C_{fmv} or C_{int} .⁶⁵ The losing side "spent" only C_{int} , so placing the indemnification limit at C_{fmv} would require the

60. See, e.g., Ehrenzweig, *supra* note 5, at 792-93.

61. *Id.* at 794.

62. See *supra* text accompanying note 48.

63. Cf. Crovitz, *supra* note 31, at A14 (most personal injury cases brought on contingency-fee basis).

64. The Supreme Court has ruled that the defendant's indemnification burden under a statutory fee-shifting provision is not limited by the prevailing plaintiff's contingency contract — C_{fmv} governs. *Blanchard v. Bergeron*, 489 U.S. 87 (1989).

65. This raises the peripheral question of how to assess and monitor C_{fmv} and C_{int} . The parties' attorneys would presumably report their hours to the court. However, reporting legal hours after the judgment is issued would be impractical. If the judgment were nominal and for the plaintiff, the plaintiff's attorney would have a large incentive to inflate C_{fmv} . If the defendant prevailed and indemnification under the PCC rule were limited to C_{fmv} or C_{int} , there would be a strong tendency to understate the plaintiff's legal costs. The best solution would require that hours be reported to the court on a regular basis, such as monthly, in the period commencing with filing of the claim and proceeding up to the time of judgment.

Attorneys paid on an hourly basis have a strong incentive to overstate their costs to inflate ultimate recovery, but under the PCC rule lower billings might limit indemnification. Incentives for hourly rate attorneys would probably be largely self-policing, assuming attorneys charge clients amounts that are consistent with those provided to the court.

Conversely, contingency-fee lawyers have a strong incentive to understate costs under the PCC rule to limit indemnification. Again, this tendency is checked by the possibility that the prevailing contingency fee attorney may recover fees calculated on the basis of reported legal costs if damages are nominal. The opposing attorney will also contest obviously underreported hours. The court, too, should question suspicious reports of very low hours. Finally, hours reported to

loser to indemnify the winner at a higher level than expenses. As discussed above, however, when the prevailing plaintiff recovers only nominal damages, the defendant should pay the plaintiff's attorney the fair market value of his work, C_{fmv} , rather than C_{int} . Because a losing defendant must pay at least the higher C_{fmv} , reciprocity obliges the losing plaintiff to indemnify the defendant at that rate. Moreover, limiting indemnification to the true internal cost felt by the plaintiff's attorney seems artificial, may be more open to adverse attorney manipulation, and in any case denies the prevailing defendant a portion of the recovery that she would receive if the plaintiff had used an hourly attorney. Thus, plaintiff's indemnification limit under the PCC rule should be C_{fmv} .

To summarize, the losing defendant should normally be required to pay the full contingency fee, βJ . When the plaintiff prevails with only nominal damages, the defendant should pay the plaintiff's attorney C_{fmv} under either the British or PCC rules. When the defendant prevails under the British rule, she is entitled to full indemnification for her fees. However, under the PCC rule, her recovery should be limited by C_{fmv} . The only role C_{int} plays in this Note is to assess the plaintiff attorney's expected economic benefits.⁶⁶

The third and final preliminary question is whether the plaintiff's own perspective or that of his attorney should be adopted in assessing the likelihood of settlement. Part I assumed that the underlying parties estimated costs and probabilities which dictated the settlement conditions. In a contingency fee arrangement, however, the plaintiff and his attorney will have markedly different conditions for settlement. In fact, under most plausible circumstances, the contingency-fee attorney will consistently benefit if he can obtain a reasonable settlement from the defendant and forego the expenses of trial.⁶⁷ If a plaintiff retains an attorney who is able to lay aside personal considerations of profit, or at least is scrupulously ethical in pursuing only his client's best interests, the settlement decision should be analyzed from the plaintiff's perspective. The legitimacy of this presumption is clearly a matter of conjecture.

Adopting the plaintiff's perspective on settlement may make more sense under the British and PCC rules. The plaintiff may well play a larger role in the settlement process under an indemnification scheme, particularly if the plaintiff is the indemnitor and not his attorney. Moreover, higher stakes will logically create a greater incentive for confident plaintiffs to spur their attorneys on to litigation.⁶⁸ Such

the court should be provided to the client; if the hours are suspiciously low, the client may confront the attorney or even seek another lawyer who will work harder.

66. See *infra* equation (14).

67. See *infra* equations (16) and (17) and accompanying text.

68. See *infra* appendix; *supra* note 22 and accompanying text.

plaintiffs will be less likely to accept a small fraction of their claims due to the higher rewards of winning under a fee-shifting rule.

This Note analyzes settlement conditions under the various fee-shifting rules using each of the alternate perspectives, the plaintiff's and his attorney's. Both are useful. The plaintiff's perspective reflects an ideal lawyer-client relationship where the lawyer devotes himself to furthering only the client's interests. Cynics may contend that the attorney's perspective more closely reflects reality, but viewing settlement from the contingency-fee attorney's perspective overpredicts settlement when variables are replaced by realistic values. Conversely, comparing the settlement conditions from the plaintiff's perspective probably underpredicts settlement frequency in practice.⁶⁹ Examining the settlement conditions from both perspectives best fulfills the purpose of this Note: to predict the direction and magnitude of the change in settlement frequency under the three fee-shifting rules.

B. *Expected Benefits and Costs Under the Three Fee-shifting Rules and Contingent Attorney Compensation*

The following economic analysis examines the impact of the three fee-shifting rules — American, British, and PCC — when the plaintiff pursues his claim under a contingency fee arrangement with his attorney. The concepts and terms used below mirror the analysis in Part I. For each fee-shifting rule, the expected benefit or cost is determined for the plaintiff, the plaintiff's lawyer, and the defendant, denoted F , F_{law} , and f , respectively. The terms introduced in the preceding section are also used: β (contingency fee percentage), C_{fmv} (fair market value of plaintiff lawyer's legal services), and C_{int} (internal cost of plaintiff lawyer's legal work). This section incorporates the assumptions examined in section II.A above: (1) β is constant; (2) the successful plaintiff's attorney normally recovers βJ ; and (3) if the plaintiff prevails with only nominal damages or a declaratory judgment under the British and PCC rules, the defendant pays plaintiff's attorney a reasonable rate for his work, C_{fmv} .

1. *American Rule*

The plaintiff's expected benefit, F , under the American rule is the probability of victory times the plaintiff's share of the expected judgment amount:

$$F = (1 - \beta)PJ. \quad (13)$$

The plaintiff lawyer's expected benefit, F_{law} , after deducting for internal costs of pursuing the claim is

69. Compare settlement conditions from the plaintiff's perspective, *infra* note 77 with settlement conditions from his lawyer's perspective, *infra* note 90.

$$F_{law} = \beta PJ - C_{int}. \quad (14)$$

Defendant's expected cost, f , is simply

$$f = pj + c. \quad (15)$$

Before continuing with the fee-shifting comparison, note how the settlement conditions differ depending on whose perspective is adopted, plaintiff's or his attorney's. For settlement to occur, the expected cost to the defendant must exceed the expected benefit to the plaintiff (or his attorney). From the plaintiff's viewpoint, this condition is expressed by

$$\begin{aligned} (1 - \beta)PJ &\leq pj + c \\ \text{or} \\ (1 - \beta)PJ - pj &\leq c. \end{aligned} \quad (16)$$

The condition from the plaintiff attorney's perspective is

$$\begin{aligned} \beta PJ - C_{int} &\leq pj + c \\ \text{or} \\ \beta PJ - pj &\leq C_{int} + c. \end{aligned} \quad (17)$$

The more easily these conditions are satisfied, the more often settlement will occur. Clearly the settlement condition will always be satisfied more easily from the lawyer's perspective. The LHS of the settlement condition from the lawyer's perspective (17) will always be less than the LHS of the settlement condition from the plaintiff's perspective (16) so long as β is less than fifty percent. More importantly, the RHS of the settlement condition will always be larger from the lawyer's perspective because the lawyer would like to avoid incurring the internal costs of trial, C_{int} . Thus, because the attorney expects to receive less money from a potential judgment than the plaintiff and because he will incur any costs of trial, the lawyer will always have greater personal incentive to seek settlement than his client.

2. British Rule

Analysis of the British rule under the contingency system is bifurcated, depending on whether the plaintiff or his attorney is the responsible indemnifying party. When the plaintiff must indemnify under the British rule, he expects to receive the entire judgment amount, J , if successful at trial. His expected benefit is discounted, however, by the risk of paying the defendant's legal costs:

$$F = PJ - (1 - P)c. \quad (18)$$

The plaintiff attorney's expected benefits under the British rule would normally be identical to the expected benefits under the American rule:

$$F_{law} = \beta PJ - C_{int}.$$

As discussed in section II.A, however, the plaintiff may prevail at trial but recover only nominal damages. In that case, plaintiff's attorney would not receive βJ but C_{fmv} . When this possibility is considered, the better representation of the attorney's expected benefits is

$$F_{law} = P[\max(\beta J, C_{fmv})] - C_{int}. \quad (19)$$

When the plaintiff's lawyer is responsible for paying the prevailing defendant's attorney fees under the British Rule, the expected benefit equations for the plaintiff and his attorney are

$$F = PJ \quad (20)$$

$$F_{law} = P[\max(\beta J, C_{fmv})] - (1 - P)c - C_{int}. \quad (21)$$

The defendant's expected costs are the same regardless of whether the plaintiff or his lawyer assumes indemnification responsibility:

$$f = p[j + \max(\beta j, C_{fmv})] - (1 - p)c + c. \quad (22)$$

3. PCC Rule

Finally, the PCC fee-shifting rule limits indemnification to the loser's own legal costs. Like the pure British rule, the analysis is bifurcated, depending on whether the plaintiff or his attorney indemnifies the winning defendant.

Because indemnification under the PCC rule will often be limited, the deficit in legal fee compensation must either be borne by the prevailing party or by the successful attorney. Obviously an attorney engaged on an hourly basis will demand full payment regardless of the outcome of trial. Similarly, many plaintiff attorneys may insist on full contingency fee compensation, βJ , leading to less than full recovery by the plaintiff. Other contingency-fee attorneys, however, may be willing to risk compensation limited by opposing counsel expenses; this is especially likely where the defendant is expected to incur substantial legal costs. The economic analysis requires choosing whether the successful plaintiff or his attorney should absorb the fee deficit under limited indemnification. This section and the following section analyze the economic incentives under both conditions.

PCC Version 1, Attorney Compensation Limited: The plaintiff's lawyer will bear the risk of limited compensation when the presumptive rule is that the plaintiff should be kept whole, notwithstanding his lawyer's success at trial. The expected benefits to the plaintiff and his attorney when the plaintiff indemnifies are

$$F = PJ - (1 - P)\min(C_{fmv}, c) \quad (23)$$

and

$$F_{law} = P\{\min[\max(\beta J, C_{fmv}), c]\} - C_{int}. \quad (24)$$

The expected benefits to these parties when the attorney indemnifies are

$$F = PJ \quad (25)$$

and

$$F_{law} = P\{\min[\max(\beta J, C_{fmv}), c]\} - (1 - P)\min(C_{fmv}, c) - C_{int}. \quad (26)$$

The defendant's expected cost is again the same whoever indemnifies:

$$f = p\{j + \min[\max(\beta j, C_{fmv}), c]\} - (1 - p)\min(C_{fmv}, c) + c. \quad (27)$$

PCC Version 2, Plaintiff Compensation Limited: The plaintiff's lawyer will be fully compensated if the plaintiff remits to the lawyer any shortfall in indemnification. In such a case the plaintiff is worse off than under a pure British rule, but better off than under the American rule. The expected benefits to the plaintiff and his attorney under such an arrangement, when the plaintiff indemnifies, are

$$F = P\{J - \beta J + \min[\max(\beta J, C_{fmv}), c]\} - (1 - P)\min(C_{fmv}, c) \quad (28)$$

and

$$F_{law} = P\beta J - C_{int}. \quad (29)$$

The expected benefits to these parties when the attorney indemnifies are

$$F = P\{J - \beta J + \min[\max(\beta J, C_{fmv}), c]\} \quad (30)$$

and

$$F_{law} = P\beta J - (1 - P)\min(C_{fmv}, c) - C_{int}. \quad (31)$$

The defendant's costs remain the same as in equation (27).

C. Settlement Conditions Under Contingency Fee

In this section, the expected gains and costs developed in the preceding section are used to compare the likelihood of settlement under the three fee-shifting rules when the plaintiff's lawyer is paid contingent on recovery. The following analysis examines the settlement conditions under the three fee-shifting rules from both the plaintiff's and the plaintiff attorney's perspectives. The alternative parties responsible for the plaintiff's indemnification duty, lawyer or client, are also both examined below. This approach creates four scenarios: (1) plaintiff's perspective of the settlement condition with the plaintiff as indemnitor; (2) plaintiff's perspective with his attorney as indemnitor; (3) plaintiff attorney's perspective of the settlement condition with the plaintiff as indemnitor; and (4) plaintiff attorney's perspective with the attorney as indemnitor.

The analytical approach of this section parallels the methodology employed in Part I.⁷⁰ This section asserts that, regardless of whose

70. Unfortunately, the equations in this section are substantially more complicated than those developed in Part I; the same main ideas, however, underlie the formulas.

perspective is adopted or who bears responsibility for indemnification, a facial examination of the settlement conditions indicates more settlements under the American rule. However, because costs and parties' assessments of success change under the three different fee-shifting rules, settlement when a contingency-fee attorney represents the plaintiff is again probably more likely under the British and PCC rules.

Case 1: Plaintiff Perspective, Plaintiff Indemnifies

Settlement will occur under the American rule when the plaintiff's expected gains, F , are less than or equal to the defendant's expected costs, f . Substituting from equations (13) and (15):

$$(1 - \beta)PJ \leq pj + c.$$

Settlement under the British rule requires substitutions from (18) and (22):

$$PJ - (1 - P)c \leq p[j + \max(\beta j, C_{f_{mv}})] - (1 - p)c + c.$$

The settlement condition for the PCC rule depends on whether the plaintiff or his lawyer risks limited compensation. Assuming first that the plaintiff is kept whole and the lawyer absorbs any deficit (PCC version 1), the settlement condition is derived from equations (23) and (27):

$$PJ - (1 - P)\min(C_{f_{mv}}, c) \leq p\{j + \min[\max(\beta j, C_{f_{mv}}), c]\} - (1 - p)\min(C_{f_{mv}}, c) + c.$$

When the attorney is confident of full compensation (PCC version 2), the LHS is replaced by (28):

$$P\{J - \beta J + \min[\max(\beta J, C_{f_{mv}}), c]\} - (1 - P)\min(C_{f_{mv}}, c) \leq p\{j + \min[\max(\beta j, C_{f_{mv}}), c]\} - (1 - p)\min(C_{f_{mv}}, c) + c.$$

The above conditions may be rearranged to facilitate comparison:⁷¹

$$0 \leq pj - PJ + P\beta J + c \quad (32)$$

$$0 \leq pj - PJ + p[\max(\beta j, C_{f_{mv}})] - (P - p)c + c \quad (33)$$

$$0 \leq pj - PJ + p\{\min[\max(\beta j, C_{f_{mv}}), c]\} - (P - p)\min(C_{f_{mv}}, c) + c \quad (34)$$

$$0 \leq pj - PJ + \{P\beta J - (P - p)\}\min[\max(\beta j, C_{f_{mv}}), c] - (P - p)\min(C_{f_{mv}}, c) + c. \quad (35)$$

71. The last PCC equation as simplified implicitly assumes that $J = j$ in the second term; this assumption is repeated in equation (39) *infra* for Case 2. This simplification has been implicit throughout this Note for all of the fee-shifting rules. See *supra* note 25.

The four equations represent the conditions necessary for settlement to occur under the rules: American (32), British (33), PCC with plaintiff kept whole (34), and PCC with plaintiff's lawyer kept whole (35). The greater the RHS, the more likely settlement will occur.

If the parties' legal costs and assessments of success remain constant under different fee-shifting rules, the first equation is clearly more often satisfied, implying that the American rule will result in more settlements than either the British or PCC rules. This is so for two reasons: first, because $P > p$, $P\beta J$ will always be greater than the corresponding terms below; second, the last three equations include a negative term absent from the American rule.

As Part I of this Note argued, however, to assume that probabilities and costs will remain constant as the fee-shifting rules change is unreasonable. Indemnification automatically raises the stakes of the controversy, and litigation costs will probably increase considerably,⁷² perhaps twofold.⁷³ Furthermore, the gap between the parties' estimates of plaintiff success ($P - p$) will likely contract as risk-averse parties become more conservative in their assessments — the plaintiff will tend to hedge toward the low side for P , while the cautious defendant will increase her estimate of the plaintiff's chances, p . The first term of the equations, $pj - PJ$, will thus contract and become less negative under the British and PCC rules. This contraction in the first term under indemnification will often offset the reduction seen in the second term under indemnification.

For example, if P and p are 0.7 and 0.3 under the American rule and converge under the British rule to 0.6 and 0.4 respectively, a $0.2J$ gain is realized in the first term under indemnification (assuming J and j are equal). The second term under the American rule equals $0.7\beta J$. Under the British rule, assuming a substantial judgment, the second term equals $0.4\beta J$; thus, moving from the American rule to the British rule reduces the second term by $0.3\beta J$. If β is one third, the second term is less positive by $0.1J$ under the British rule. This reduction is only half the gain realized in the first term in moving to the British rule; therefore, settlement would more likely result under the British rule given these realistic assumptions.

Although the newly introduced third term in all three indemnification settlement conditions is negative and detracts from the likelihood of settlement, increased legal costs will normally offset this term's impact. The probability gap ($P - p$) will often be less than 0.5;⁷⁴ any greater disparity in the parties' expectations of success would severely reduce the likelihood of settlement under the American rule. The con-

72. See *supra* note 22 and accompanying text.

73. Katz, *supra* note 9, at 167.

74. Cf. Hause, *supra* note 9, at 167 (finding it unlikely that $P - p$ is "large" relative to 1 due to professional advice from lawyers).

vergence effect discussed above strengthens this assumption under conditions of indemnification. Doubling the defendant's legal costs, c , would thus overcome the effects of this negative term as compared to the American rule.

Suppose c were \$1000 under the American rule and doubled under the British rule to \$2000, and that $P - p = 0.4$ under the British rule (33). The third term under this rule's settlement condition will equal negative \$800. This negative number is less in absolute terms than the \$1000 increase in c . The RHS thus undergoes a net increase, resulting in a greater likelihood of settlement under the British rule. The above analysis is even more compelling for both versions of the PCC rule. The third term of both PCC rule equations is less negative than (or equal to) the third term of the British rule; thus, these terms under the PCC rule would appear to promote more settlements than the corresponding terms under the British rule. Moreover, if the probability gap is narrower, the expected increase in legal costs need not be as great.⁷⁵

The settlement condition for the PCC rule contains limits on indemnification that attenuate the critical terms of the British-rule settlement condition. Limits on indemnification, which tend to lower the stakes as compared to the British rule, also dampen incentives to increase legal expenditures or to revise probability estimates.⁷⁶ So while partial indemnification will tend to drive up the parties' legal costs of going to trial, the increase will be less than the British rule. Intuitively, however, it seems likely that the parties will nevertheless significantly temper their estimates of success, as compared to the American rule, given the risk of partial indemnification; $P - p$ under the PCC rule will probably approach the contraction level predicted under the British rule. This is especially true for plaintiffs, who risk nothing under the American rule, and nonwealthy litigants who probably prefer to avoid risk. Thus, although legal costs will increase less under the PCC rule, one expects settlement under the rule to approach that of the British rule due to the likelihood of substantial probability convergence.

The first PCC settlement condition (34) assumes that the plaintiff will be kept whole and that the successful plaintiff's attorney will absorb any shortfall in indemnification from the defendant. In such a case, the plaintiff may have less incentive to settle than a British-rule plaintiff because the PCC rule limits the plaintiff's potential indemnification responsibilities. This is reflected in the second term of (34), which is less than or equal to the second term of the British-rule settle-

75. If $(P - p) = 0.3$, a 43% increase in legal costs would erase the effects of the negative third term.

76. See *supra* notes 27-30 and accompanying text.

ment condition (33); this term thus promotes less settlement than the British rule.

The second PCC settlement condition (35) assumes that the successful plaintiff will pay his attorney in full regardless of how much the defendant indemnifies. The second term of (35) thus contains a large positive cost term to the plaintiff, $P\beta J$, less an appropriate adjustment for indemnification offered by the defeated defendant. Clearly, the second term of (35) will be much more positive than the second term of (34), promoting settlement far more frequently. This is because the plaintiff faces a risk of substantial legal costs if the case proceeds to trial — risk which is avoided through settlement. Indeed, this effect under the second version of the PCC rule will often promote higher settlement rates than the British rule. This is best illustrated by a numerical example offered in the margin.⁷⁷

The divergence between the two versions of the PCC rule, dependent on placement of the successful attorney's indemnification deficit, may not be as sharp in practice as it is in theory. Regardless of where the risk might fall initially were the rule adopted, parties could contractually adjust fee arrangements to redistribute burdens and potential awards.⁷⁸ This is another application of the Coase theorem similar to that proposed for the distribution of overall indemnification risk — upon plaintiff or his attorney — under the British and PCC rules.⁷⁹ Such reallocation promotes market efficiency.

77. Assume the following: $P = 0.7$, $p = 0.3$, and $c = \$1000$ under the American rule, changing to $P = 0.6$, $p = 0.4$ under all of the indemnification rules; $c = \$2000$ under the British rule and $c = \$1700$ under the PCC rule; $C_{f,m} = \$2000$; $J = j = \$10,000$; $\beta = 33\%$. With these realistic assumptions, the RHS of each settlement condition is easily calculated.

American:

$$(3000 - 7000) + (2333) + 1000 = -667$$

British:

$$(4000 - 6000) + (0.4)[\max(3333, 2000)] - (0.2)(2000) + 2000 = 933$$

PCC #1:

$$(4000 - 6000) + (0.4)\{\min[\max(3333, 2000), 1700]\} - (0.2)[\min(2000, 1700)] + 1700 = 40$$

PCC #2:

$$(4000 - 6000) + \{2000 - (0.2)\{\min[\max(3333, 2000), 1700]\}\} - (0.2)[\min(2000, 1700)] + 1700 = 1020$$

The greater the RHS, the more likely settlement will occur. These values indicate that the parties would settle under any indemnification rule but not under the American rule. Settlement would be most likely under the second version of the PCC rule, with the plaintiff assuring his attorney full compensation βJ , and under the British rule. These are followed by the first version of the PCC rule, where the plaintiff is kept whole, and finally the American rule. Note that if $C_{f,m}$ were less than c under the PCC rule, the RHS of both PCC versions would be higher and settlement even more likely.

This and subsequent numerical examples merely illustrate the model's behavior given plausible parameters; it is not intended as a general proof of the relative likelihood of settlement under Case 1 settlement conditions. Although its results are certainly manipulable according to supplied inputs, the hierarchy of settlement likelihood between the various settlement equations is not highly sensitive to reasonable adjustments of the above inputs.

78. The plaintiff and attorney may, for example, agree to split the difference in any shortfall resulting from limited indemnification.

79. See *supra* note 48 and accompanying text.

To summarize the comparisons under Case 1: when the plaintiff's attorney is retained on a contingency basis, the plaintiff will more often favor settlement under the British rule than the American rule due to a combination of risk aversion, higher anticipated litigation costs, and more careful assessments of success. The enhanced settlement incentives will assert themselves most strongly when the parties' estimates of success are relatively close, i.e., when $(P - p)$ is less than 0.5.

Settlement likelihood under the PCC rule is sensitive to allocation of underpayment responsibility. The effect of the proposed PCC rule is unclear under the first version of the rule, where the successful plaintiff bears no responsibility to his attorney for the defendant's under-indemnification. Although the possibility of indemnifying a successful defendant will generally prompt more conservative estimates and greater legal costs, thus encouraging settlement, these factors may not overcome the greater tendency to litigate when limited fee recovery enhances the stakes.⁸⁰ The second version of the rule, where the plaintiff assures his attorney full recompense, greatly encourages settlement from the plaintiff's perspective and may surpass the British rule in promoting settlement. Under the PCC rule, it appears that settlement rates would certainly not be much reduced as compared to the American rule and might well be significantly higher.⁸¹

Case 2: Plaintiff's Perspective, Plaintiff's Lawyer Indemnifies

Section A of this Part argued for indemnification by the plaintiff, and not his contingency-fee lawyer, under the British and PCC rules.⁸² The settlement conditions when the plaintiff's lawyer indemnifies are examined below because many plaintiffs may contract to shift the indemnification burden to their contingency-fee attorneys. Furthermore, the analysis illustrates a consistent settlement pattern under the three fee-shifting rules.

The settlement conditions from the plaintiff's perspective when his lawyer indemnifies are as follows for the American rule, British rule, PCC rule with the plaintiff kept whole, and PCC rule with the plaintiff's attorney kept whole:⁸³

80. Further empirical research would be very helpful in assessing potential litigant behavior; i.e., litigation scenarios could be constructed and posed to sufficiently large student population groups under the three rules to determine the different rules' impacts on P , p , c , and settlement rates.

81. The plaintiff attorney's influence in reaching a settlement may play a significant role. The discussion in Cases 3 and 4, *infra*, demonstrates that his settlement incentive under either version of the PCC rule is probably substantially larger than under the American rule.

82. See *supra* text accompanying notes 42-48.

83. The settlement conditions for the American rule utilize equations (13) and (15); British rule (20) and (22); PCC rule version 1 (25) and (27); and PCC rule version 2 (30) and (27).

$$(1 - \beta)PJ \leq pj + c$$

$$PJ \leq p[j + \max(\beta j, C_{fmv})] - (1 - p)c + c$$

$$PJ \leq p\{j + \min[\max(\beta j, C_{fmv}), c]\} - (1 - p)\min(C_{fmv}, c) + c$$

$$P\{J - \beta J + \min[\max(\beta J, C_{fmv}), c]\} \leq p\{j + \min[\max(\beta j, C_{fmv}), c]\} - (1 - p)\min(C_{fmv}, c) + c.$$

These may be rearranged for comparison as follows:

$$0 \leq pj - PJ + P\beta J + c \quad (36)$$

$$0 \leq pj - PJ + p[\max(\beta j, C_{fmv})] - (1 - p)c + c \quad (37)$$

$$0 \leq pj - PJ + p\{\min[\max(\beta j, C_{fmv}), c]\} - (1 - p)\min(C_{fmv}, c) + c \quad (38)$$

$$0 \leq pj - PJ + \{P\beta J - (P - p)\}\min[\max(\beta j, C_{fmv}), c]\} - (1 - p)\min(C_{fmv}, c) + c. \quad (39)$$

The equation for the American rule is identical to the case where the plaintiff indemnifies. The RHS of the equations for the British and PCC rules, however, are smaller than the corresponding equations when the plaintiff is the indemnitor. Comparing the above equations with (33), (34), and (35), the term $(P - p)$ has increased to $(1 - p)$, making these terms more negative and settlement less likely. The relative decrease in settlement likelihood occurs simply because the plaintiff faces no risk of proceeding to trial and therefore has far less incentive to settle.

The RHS under the British and PCC rules will nonetheless often be larger than the RHS under the American rule. An example using realistic parameters is provided in the margin.⁸⁴ The probabilities P

84. Assume the same parameters given in the example in Case 1, *supra* note 77, except assume that the plaintiff's estimate of his success, P , remains 0.7 under all rules. The plaintiff in Case 2 has no indemnification responsibility under the British or PCC rules and will therefore have no incentive to adjust P downward. The RHS of each settlement condition under Case 2 is calculated as follows:

American:

$$(3000 - 7000) + (2333) + 1000 = -667$$

British:

$$(4000 - 7000) + (0.4)[\max(3333, 2000)] - (0.6)(2000) + 2000 = -867$$

PCC #1:

$$(4000 - 7000) + (0.4)\{\min[\max(3333, 2000), 1700]\} - (0.6)[\min(2000, 1700)] + 1700 = -1640$$

PCC #2:

$$(4000 - 7000) + \{2000 - (0.3)\}\min[\max(3333, 2000), 1700]\} - (0.6)[\min(2000, 1700)] + 1700 = -830$$

The higher the RHS, the more likely settlement will occur, with cases settling if greater than zero. If the parties confronted these estimates, settlement would be least likely under the PCC rule version 1 where the plaintiff is kept whole. The plaintiff under that rule risks nothing and

and p will still tend to converge under any indemnification scheme due mainly to risk-averse defendants increasing their assessments of p . The defendant's stakes in the litigation also remain larger under the British and PCC rules than under the American rule; changes in indemnification responsibility will not normally affect the rationale underlying an increase in defense expenditures, c .⁸⁵ Finally, as noted below in Case 4, lawyer indemnification substantially alters settlement incentives as viewed by a self-interested lawyer.

Case 3: Lawyer's Perspective, Plaintiff Indemnifies

An inspection of the lawyer's incentives under the fee-shifting rules yields helpful insights into the dynamics of the settlement process. For pedagogical purposes, the following analysis assumes that the lawyer has forsaken agency obligations and seeks to maximize personal gain.

For settlement to occur, the plaintiff attorney's expected gains, F_{law} , must be less than or equal to the defendant's expected costs, f . When the plaintiff indemnifies, the lawyer views the settlement conditions under the American, British, and versions one and two of the PCC rules as follows:⁸⁶

$$P\beta J - C_{int} \leq pj + c$$

$$P[\max(\beta J, C_{fmv})] - C_{int} \leq p[j + \max(\beta j, C_{fmv})] - (1 - p)c + c$$

$$P\{\min[\max(\beta J, C_{fmv}), c]\} - C_{int} \leq p\{j + \min[\max(\beta j, C_{fmv}), c]\} - (1 - p)\min(C_{fmv}, c) + c$$

$$P\beta J - C_{int} \leq p\{j + \min[\max(\beta j, C_{fmv}), c]\} - (1 - p)\min(C_{fmv}, c) + c.$$

receives full undiluted judgment if successful, and the defendant's expected costs are reduced by a probability of indemnification. The outcomes under the other three rules are all roughly equal and would readily shift position with modest adjustments of the variables.

85. The plaintiff's attorney may be more likely than the plaintiff to pay indemnification obligations to the winning defendant due to creditworthiness and concerns for professional reputation. If defendants perceive this to be true, the stakes will be correspondingly higher when the attorney indemnifies than when the plaintiff indemnifies, leading to higher expected legal expenditures and enhanced probability of settlement.

86. The settlement conditions for the American rule utilize equations (14) and (15); British rule (19) and (22); PCC rule version 1 (24) and (27); and PCC rule version 2 (29) and (27).

In order to simplify the expressions and facilitate comparison, assume explicitly that the parties' estimates of expected trial judgment, J and j , are equal under all rules.⁸⁷ Rearranging the above equations:

$$0 \leq pJ - P\beta J + C_{int} + c \quad (40)$$

$$0 \leq pJ - (P - p)\max(\beta J, C_{fmv}) - (1 - p)c + C_{int} + c \quad (41)$$

$$0 \leq pJ - (P - p)\min[\max(\beta J, C_{fmv}), c] - (1 - p)\min(C_{fmv}, c) + C_{int} + c \quad (42)$$

$$0 \leq pJ - \{P\beta J - p\{\min[\max(\beta J, C_{fmv}), c]\}\} - (1 - p)\min(C_{fmv}, c) + C_{int} + c. \quad (43)$$

Again, settlement is more likely to occur when the RHS is large.

Varying the fee-shifting rules from the contingency-fee lawyer's perspective has several significant effects on settlement likelihood. First, indemnification introduces a relatively large negative term $(1 - p)$ into the RHS of the last three settlement conditions, making settlement less likely. The impact of this term is blunted, however, by the second term under the British and PCC settlement equations; the second term will nearly always be far less negative and more conducive to settlement than the second term under the American rule. Second, as explored previously in other indemnification contexts, the heightened stakes will tend to increase p .⁸⁸ If p is large enough to prompt settlement under the American rule in the first equation, p 's inflated value under indemnification will strongly affect the first three RHS terms under the British and PCC rules, making the RHS more positive and increasing the likelihood of settlement. Finally, large increases predicted in both the defendant's external legal costs, c , and the contingent attorney's own internal costs, C_{int} ,⁸⁹ will commonly overcome the negativity of the third terms under indemnification rules — the impact of $(1 - p)c$ under the British rule and the corresponding terms below under the PCC rule will be small compared to the relative increase in c and C_{int} .

The sum of the above effects strongly suggests that attorneys would be more likely to advocate settlement under either rule of plain-

87. See *supra* note 25.

88. The plaintiff attorney's estimate of the probability of success, P , will probably not change much from the American rule because the attorney does not bear the risk of indemnification. Cf. *supra* note 84 (discussing similar stability for plaintiff's probability estimate in Case 2).

89. See *supra* note 22 and accompanying text.

tiff indemnification. A numerical example is again set in the margin.⁹⁰ As discussed previously, limited indemnification under the PCC rule would result in less dramatic increases in legal costs and perhaps somewhat more modest revisions of the defendant's probability estimate p . Because the PCC rule is essentially an intermediate position between the American and British rules, the PCC rule would also tend to result in more settlements than the American rule. The settlement incentives encountered by a contingency-fee attorney litigating under the two indemnification rules differ only in degree.

Case 4: Lawyer's Perspective, Lawyer Indemnifies

The final inquiry is whether settlement is more or less likely from the plaintiff lawyer's perspective when that lawyer is responsible for indemnification. The settlement conditions are⁹¹

$$\beta PJ - C_{int} \leq pj + c$$

$$P[\max(\beta J, C_{fmv})] - (1 - P)c - C_{int} \leq p[j + \max(\beta j, C_{fmv})] - (1 - p)c + c$$

$$P\{\min[\max(\beta J, C_{fmv}), c]\} - (1 - P)\min(C_{fmv}, c) - C_{int} \leq p\{j + \min[\max(\beta j, C_{fmv}), c]\} - (1 - p)\min(C_{fmv}, c) + c$$

$$P\beta J - (1 - P)\min(C_{fmv}, c) - C_{int} \leq p\{j + \min[\max(\beta j, C_{fmv}), c]\} - (1 - p)\min(C_{fmv}, c) + c.$$

90. Because the plaintiff attorney's estimate of P will probably not change from the American rule upon shifting to an indemnification scheme, *supra* note 88, assume the same parameter values as in Case 2, *supra* note 84. Assume also that C_{int} = \$1000 under the American rule and C_{int} = \$1500 under indemnification. The RHS of each settlement condition is again easily calculated.

American:

3000 - 2333 + 1000 + 1000 = 2667

British:

4000 - (0.3)[max(3333, 2000)] - (0.6)2000 + 1500 + 2000 = 5300

PCC #1:

4000 - (0.3){min[max(3333, 2000), 1700]} - (0.6)[min(2000, 1700)] + 1500 + 1700 = 5670

PCC #2:

4000 - {(0.7)(3333) - (0.4){min[max(3333, 2000), 1700]} - (0.6)[min(2000, 1700)]} + 1500 + 1700 = 4527

Because the RHS of each equation is far greater than zero, the plaintiff attorney will always prefer settlement to trial under any fee-shifting rule under these assumptions. The likelihood for settlement is greatest under the British rule and version 1 of the PCC rule. It is smallest under the American rule, mainly because the defendant faces no prospective indemnification costs in the event of her defeat. Note that the risk of limited compensation borne by the plaintiff attorney under version 1 of the PCC rule leads to higher RHS values and a somewhat greater likelihood of settlement than when he is guaranteed his full contingency fee under version 2.

91. The benefit and cost equations for the American rule, British rule, and versions 1 and 2 of the PCC rules are taken from equations (14) and (15), (21) and (22), (26) and (27), and (31) and (27) respectively.

Rearranging and letting $J=j$ as in Case 3:⁹²

$$0 \leq pJ - P\beta J + C_{int} + c \quad (44)$$

$$0 \leq pJ - (P-p)[\max(\beta J, C_{fmv})] - (P-p)c + C_{int} + c \quad (45)$$

$$0 \leq pJ - (P-p)\min[\max(\beta J, C_{fmv}), c] - (P-p)\min(C_{fmv}, c) + C_{int} + c \quad (46)$$

$$0 \leq pJ - \{P\beta J - p\{\min[\max(\beta J, C_{fmv}), c]\} - (P-p)\min(C_{fmv}, c)\} + C_{int} + c. \quad (47)$$

These settlement equations are nearly identical to the settlement conditions examined from the lawyer's perspective when the plaintiff indemnified in Case 3. The only change is the third term under the British and PCC rules, which is now less negative because $(P-p)$ is less than $(1-p)$. From the lawyer's perspective, the RHS of the settlement conditions under indemnification rules will increase, and settlement will become more frequent than when the plaintiff indemnifies. A final numerical example may be found in the margin.⁹³ Case 3 concluded that settlement was more likely from the lawyer's perspective under plaintiff indemnification than under the American rule. The arguments supporting that conclusion are even more persuasive in the instant case: the indemnifying lawyer is understandably more inclined to seek settlement when his expected gains of going to trial have diminished so markedly. Thus, although full or partial indemnification by the lawyer may conceivably slightly reduce the plaintiff's settlement incentive from that which exists under the American rule,⁹⁴ the lawyer's enhanced desire to settle will almost certainly play a major role in the decision to litigate.

92. See *supra* equations (40) through (43) and accompanying text.

93. Both the plaintiff attorney and the defendant will adjust their estimates of plaintiff success with a move to indemnification. Thus, assume the same parameter values as in Case 1, *supra* note 77. Assume as in Case 3, *supra* note 90, that $C_{int} = \$1000$ under the American rule and that $C_{int} = \$1500$ under indemnification. The RHS of each settlement condition calculates as follows: American:

$3000 - 2333 + 1000 + 1000 = 2667$

British:

$4000 - (0.2)[\max(3333, 2000)] - (0.2)2000 + 1500 + 2000 = 6433$

PCC #1:

$4000 - (0.2)\{\min[\max(3333, 2000), 1700]\} - (0.2)[\min(2000, 1700)] + 1500 + 1700 = 6520$

PCC #2:

$4000 - \{2000 - (0.4)\{\min[\max(3333, 2000), 1700]\}\} - (0.2)[\min(2000, 1700)] + 1500 + 1700 = 5540$

The hierarchy of settlement likelihood conforms with Case 3, where the plaintiff indemnified, but the RHS values are significantly higher than Case 3, indicating even greater likelihood of settlement. The plaintiff attorney will usually strongly prefer to avoid trial and the attendant risk of indemnifying a victorious defendant under this final case.

94. See *supra* text accompanying notes 80-81.

CONCLUSION

The most recent contributions to the large body of literature examining the economic impact of claims brought under the American and British fee-shifting rules indicate strongly that tried cases would tend to be more expensive under the British rule. These higher costs will usually foster settlement despite the inhibitory impact of legal costs "discounted" due to the probability of fee recovery if successful. Limited fee indemnification, as proposed by the President's Council on Competitiveness, would mitigate inflated legal costs and their effects on settlement rates. Moreover, this intermediate position moderates the possible harsh effects of a pure loser-pays scheme by limiting the stakes involved, especially the penalty of losing to a defendant who has spent heavily.

The most important issue raised when examining settlement under the British and PCC rules is whether the plaintiff or his contingency-fee attorney should bear the indemnification burden. Philosophical considerations of agency and plaintiff responsibility suggest the plaintiff should bear the risk. More importantly, placing the burden on the attorney exacerbates divergent lawyer/client settlement interests which are now apparent under the current American rule.

The settlement effects of fee shifting in a contingency context generally coincide with the indemnification effects observed under hourly fee circumstances. Bearing the risk of indemnification will lead the plaintiff to prefer settlement. Where the attorney is responsible for indemnification, the plaintiff has far less incentive to settle than does the attorney; however, the attorney may play a large role in the plaintiff's settlement decision, and thus settlement rates may actually increase when he indemnifies and places his interests ahead of his client's. In all of the cases considered, the British rule and the second version of the PCC rule, where the plaintiff guarantees his attorney full compensation if successful, should promote the most settlement. The American rule is least conducive to settlement, while the first version of the PCC rule, where the plaintiff is kept whole, occupies an intermediate position.

By limiting the stakes of proceeding to trial, the PCC rule seems to represent a sound intermediate position between the British and American rules. The possibility of limited indemnification will deter nonmeritorious claims and protect both plaintiffs and defendants from unlimited indemnification liability. A risk-averse plaintiff may continue to utilize the contingency fee system and may even contract to place indemnification responsibility on his attorney. Other issues that may arise under the PCC rule, such as whether the successful plaintiff's attorney receives his full contingency fee or only the amount provided by the defendant, are probably best determined by the legal marketplace through contract negotiations rather than through legis-

lation or common law. The PCC rule, especially in its limited application to suits filed under federal diversity jurisdiction, seems a fair compromise toward procedural reform.

APPENDIX

Formal Derivation of Relationship Between Fee-Shifting Rule and Litigation Expenditures

Indemnity raises the stakes of the claim by making winning more lucrative and losing more costly. As the stakes rise, both parties will spend more to influence the outcome. Rational litigants will spend money on litigation until their marginal benefits equal their marginal costs.⁹⁵ The mathematical condition which describes this condition is

$$\frac{\partial F}{\partial C} = 0 \text{ and } \frac{\partial f}{\partial c} = 0.$$

Assume the following:

$$\frac{\partial P}{\partial C} > 0, \quad \frac{\partial^2 P}{\partial C^2} < 0, \quad \frac{\partial p}{\partial c} < 0, \text{ and } \frac{\partial^2 p}{\partial c^2} > 0.$$

Assume also that J and j , the parties' estimates of judgment magnitude, are unaffected by legal expenditures.⁹⁶ These mathematical conditions describe the following assumptions: As the plaintiff spends more money on legal costs, C , he strengthens his estimate of his success, P .⁹⁷ However, each dollar spent on legal fees decreases in effectiveness over the range considered.⁹⁸ Similarly, as the defendant increases her legal expenditures, she will increase her own odds and reduce her assessment of plaintiff success, p , accordingly. Her expenditures will likewise have diminishing marginal returns.

With these assumptions, the equations describing expected benefits, F , and expected costs, f , can be partially differentiated with respect to C and c respectively and set equal to zero for the American and British rules⁹⁹ to find the point where the marginal benefit of a dollar

95. The economic term for the point at which the parties independently equalize their marginal benefits and marginal costs is a "Nash equilibrium."

96. See *supra* note 26. Partial differentiation is used instead of total differentiation; thus, the following model implicitly ignores any effect of changes in C on c and vice versa. This assumption is made for ease of exposition. Hersch has demonstrated that codependence of C and c may reduce the magnitude of predicted legal cost increases under the British rule somewhat, but the assumption does not change the conclusion. Hersch, *supra* note 26, at 240 & n.11.

97. Recall that C and c are the legal costs of going to trial. The conditions will not apply to initial research costs, filing of the claim, etc. The cost range relevant to the analysis begins after the decision to proceed to trial has been made.

While the conditions as stated are generally true over the relevant range, undoubtedly circumstances arise where increasing legal expenditures, e.g., through intensive discovery, will lower estimates of success and presumably increase inducement to settle. The analysis ignores this situation because such adverse discoveries will normally occur relatively early regardless of the fee-shifting rule; this analysis concerns expenditures at the margin.

98. This is the familiar law of diminishing marginal returns. As dollars are spent on legal resources, while other inputs are held constant, the resulting incremental gains will decrease beyond some point. EDGAR K. BROWNING & JACQUELENE M. BROWNING, *MICROECONOMIC THEORY AND APPLICATIONS* 175-80 (2d ed. 1986).

99. The modified PCC rule is not continuous over C and c and so can not be readily differentiated.

spent on legal expenses equals the marginal cost. Differentiating the equations for the American rule:

$$F = PJ - C$$

$$\frac{\partial F}{\partial C} = \frac{\partial P}{\partial C}J - 1 = 0, \quad \text{thus } \frac{\partial P}{\partial C} = \frac{1}{J}$$

$$f = pj + c$$

$$\frac{\partial f}{\partial c} = \frac{\partial p}{\partial c}j + 1 = 0, \quad \text{thus } \frac{\partial p}{\partial c} = \frac{-1}{j}$$

and the British rule:

$$F = P(J + C) - (1 - P)c - C$$

or

$$F = P[J + (C + c)] - (C + c)$$

$$\frac{\partial F}{\partial C} = \frac{\partial P}{\partial C}[J + (C + c)] + P - 1 = 0$$

thus

$$\frac{\partial P}{\partial C} = \frac{1 - P}{J + (C + c)}$$

$$f = p(j + C) - (1 - p)c + c$$

or

$$f = p[j + (C + c)]$$

$$\frac{\partial f}{\partial c} = \frac{\partial p}{\partial c}[j + (C + c)] + p = 0$$

thus

$$\frac{\partial p}{\partial c} = \frac{-p}{j + (C + c)}$$

The important comparison is between the values of $\partial P/\partial C$ and $\partial p/\partial c$ under the British rule and under the American rule. Recall these expressions represent the values of the plaintiff's and defendant's last legal dollars spent on influencing the probability of the plaintiff's success. The numerators are smaller under the British rule and the denominators larger; thus, fees spent at the margin under the British rule accomplish less than fees spent at the margin under the American rule. Because the model assumes that P increases with C and p decreases with c at decreasing rates, the lower marginal utilities mean that the parties' expenditures of going to trial (C and c) will be larger under the British rule.

The stakes under the PCC rule lie somewhere between the stakes under the American and British rules. Marginal expenditures $\partial F/\partial C$ and $\partial f/\partial c$ will also be intermediate, implying lower trial costs under the PCC rule than the British rule but higher costs than under the American rule.