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The Psychology Of Hourly Fee Arrangements

By **J.B. Heaton**

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Despite the great flexibility lawyers and clients have in fashioning fee arrangements in high-stakes civil cases, the hourly-fee model remains dominant, especially on the defense side. The survival of the hourly model is intriguing because it is at odds with the predictions of law and economics scholars. It is common in the law and economics literature to examine litigation-fee arrangements as games (in the sense of game theory) between clients and lawyers. The case presents itself to the litigant, the client and lawyer choose a fee arrangement, the lawyer invests effort, and the litigation is resolved at least partly as a function of the lawyer's effort.


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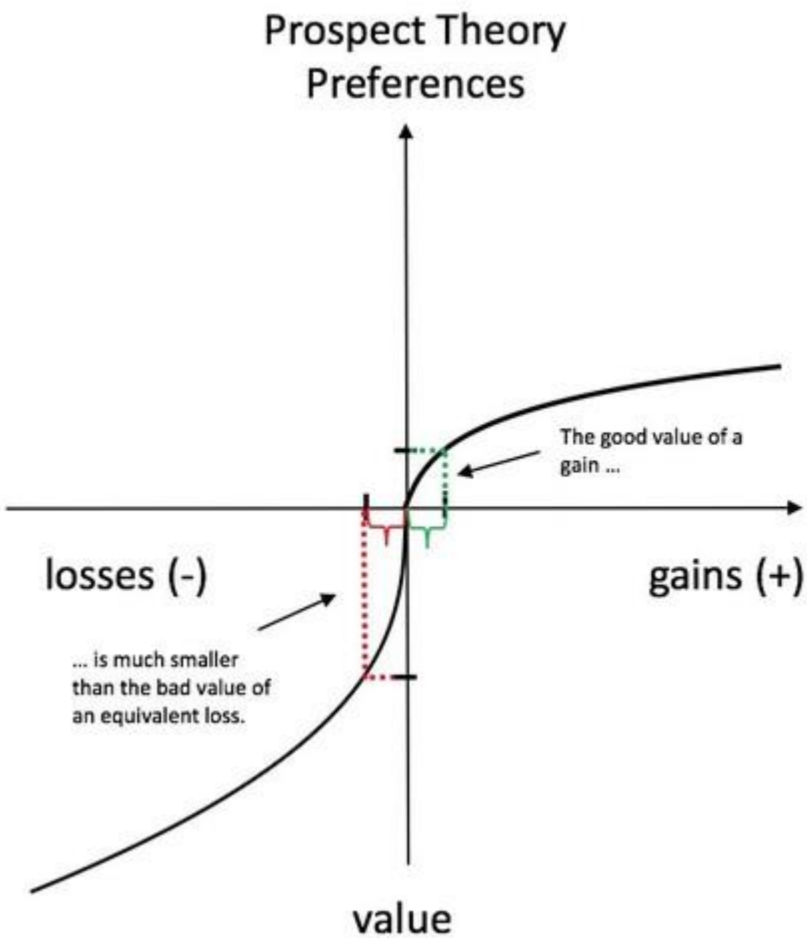
If there is one takeaway from this scholarship it is that the hourly fee is rarely the best strategy for a client in a game with his lawyer. Hourly fee arrangements create bad incentives for lawyers, most notably the incentive to bill more hours than the matter requires or, more precisely, to spend time on matters that are not cost-justified for the client. As economists see it, the hourly fee lawyer benefits from a further increment of work when the expected payment from the client for that increment of work exceeds the lawyer's opportunity cost of time (i.e., what the lawyer could expect to gain in the alternative use of her time). If the lawyer can collect $800 for an additional hour of work on the client's matter, but the alternative use of her time is worth less than $800, she will want to work the additional hour. The alternative use of her time could be work on another client's matter or the value to the lawyer of her leisure time, such as time spent at the gym, on hobbies, or with her family and friends. The client benefits from the increment of work whenever the impact on the value of his case exceeds his payment to the lawyer. Since the lawyer and the client are making different calculations (comparing different quantities at the margin), the result can be that lawyers work more hours than clients want.

Why the hourly fee arrangement remains so popular despite ongoing predictions of its demise remains something of a mystery, but there is a powerful psychological explanation. Psychology also can explain why hourly fee arrangements are more pervasive on the defense side than the plaintiff side. That explanation was developed by two Israeli scholars, law professor Eyal Zamir and psychology professor Ilana Ritov, both of Hebrew University, in work that deserves more real-world attention.

In a 2010 article[1] in The Journal of Legal Studies, Professors Zamir and Ritov apply the concept of "loss aversion" to the selection of legal-fee arrangements. Loss aversion is a component of "prospect theory preferences," the theory of decision-making preferences over risky gambles developed by Nobel Prize winner Daniel Kahneman and Amos Tversky.[2] Kahneman and Tversky showed that individuals are highly loss averse. Professors Zamir and Ritov take prospect theory and loss aversion to the legal services market. To understand the implications of prospect theory, it is useful to look at the following figure:



In prospect theory, the psychological impact of an event stems from how it changes the status quo. Increases in wealth (gains) have diminishing effect on happiness. This is the same as we are used to thinking of in traditional economics, the effects of risk aversion and diminishing marginal utility. A sure thing is worth more than a gamble of equivalent expected value and the fourth Big Mac is less enjoyable than the first. But in the domain of losses, prospect theory is quite different. Individuals with prospect theory preferences (and the experimental evidence suggests that this is most of us) hate losses much more than they enjoy equivalent gains. Individuals with prospect theory preferences hate losses so much that they are risk seeking, not risk averse, in the domain of losses.

How does this translate to the hourly fee arrangement? Applied to high-stakes civil litigation, hourly fees paid are sure losses, paid whether the client wins or loses. Consider a defense-side client that has prospect theory preferences (is loss averse) and faces a case that has a 50 percent chance of a $90 million loss and a 50 percent chance of a victory (no loss). If the client uses an hourly fee arrangement that costs $10 million (regardless of outcome) then the expected loss of the case is -(0.5 x $90 million) -

$10 million = -$55 million.

If the client instead paid the lawyer on a performance basis, say $5 million for a loss but $15 million for a victory, the expected value is the same, -(0.5 x ($90 million + $5 million) - (0.5 x $15 million) = -$47.5 million - $7.5 million = -$55 million. But the hourly fee arrangement leads to a (lose, win) pair of (-$100 million, -$10 million) while the performance-based fee leads to a (lose, win) pair of (-$95 million, -$15 million). Because the client is loss averse, the pain of the extra $5 million paid in the "win" scenario (when losses are small) hurts more (psychologically) than the pain of the extra $5 million paid in the "lose" scenario (when losses are already large), so the client will prefer the hourly arrangement.

Even if the client believes that performance-based fees would improve the probability of loss or the size of the judgment, the incentive effects would have to be large enough to warrant the psychological pain of the extra compensation paid to the lawyer in the event of a victory. This example sets the expected losses equal, but loss aversion may lead defense-side clients to avoid even performance-based fee arrangements that offer better expected values than the hourly arrangement, thus sacrificing (often corporate) resources to take a bad hourly fee arrangement without a performance-based element simply to avoid the psychological pain of paying higher fees in the event of a "win" than in the event of a "loss."

The power of the prospect theory explanation is that it also explains why plaintiffs prefer contingency fees even when they can afford to pay hourly fees. Loss averse preferences imply that plaintiffs would rather trade gains in the state of a "win" to insure no certain expenses in the form of hourly fees in the event of a possible "loss" of (smaller) hourly fees. Consider a plaintiff-side client that has prospect theory preferences (is loss averse) and faces a case that has a 50 percent chance of a $90 million victory and a 50 percent chance of a loss. If the client uses an hourly fee arrangement that costs $10 million (regardless of outcome) then the expected gain of the case is +(0.5 x $90 million) - $10 million = +$35 million. If the client instead paid the lawyer on a performance basis, say $0 for a loss but $20 million for a victory, the expected value is the same, +(0.5 x ($90 million - $20 million) = +$35 million. But the hourly fee arrangement leads to a (lose, win) pair of (-$10 million, $80 million) while the performance-based (contingency) fee leads to a (lose, win) pair of ($0 million, $70 million). Because the possible $10 million loss from hourly fees looms much larger than the $10 million given up when the plaintiff already has $70 million, the prospect theory plaintiff prefers the contingency fee to the hourly fee.

The psychological explanation — one that rests on loss aversion by litigants — can thus explain the dominance of the hourly fee arrangement on the defense side that coexists with a larger prevalence of performance-based fees on the plaintiff side. If true, the behavioral explanation suggests that many current fee arrangements are probably suboptimal. Defendants may be sacrificing gains in reducing the probability of loss and decreasing the size of the judgment by failing to give their lawyers incentives to win. Plaintiffs may be sacrificing too much of their upside to avoid paying any fees in the event of a loss. The optimal answer probably lies somewhere in between. More careful consideration of the psychological factors at play may finally move fee agreements to a better place for both client and lawyer. It is difficult to believe that the defense-plaintiff split should be as important as it is. Both sides are engaged in a contest to move a probability of judgment and the size of the judgment. In high-stakes matters, the outcome of that contest is likely to swamp the amount of reasonable attorneys' fees. A move toward optimality probably requires more performance-based fees on the defense side and less performance-based compensation on the plaintiff side. The incentive problems of the hourly model suggest the possibility that it is suboptimal for both sides, but its survival value in the market simultaneously suggests some caution in that conclusion.

An intriguing possibility is that the rise of litigation funders like Burford Capital may move many fee arrangements closer to optimality. By providing nonrecourse litigation financing (i.e., financing of fees and expenses that the litigant need not repay in the event of loss), litigation funders may reduce the effective hourly rate paid by plaintiffs to their lawyers in the form of contingent fees by providing more money up front and with certainty to plaintiffs' lawyers. At the same time, litigation funders may be able to address problems on the defense side. But it seems unlikely that litigation funding will become popular on the defense side if it simply raises the cost of victory to the deep-pocket defendant.

The range of possible and better fee agreements is wide. For example, a client and a lawyer may agree to an hourly arrangement where some amount of the hourly rate (or a multiple thereof) is paid only in the event of a successful outcome. Or a firm may fix the amount of a fee on a month-to-month basis, but not cap the total fee that would be paid, and make some part of the fee contingent on the outcome of the case, again, perhaps at a multiple depending on the outcome achieved.[3] These are just two examples. But such alternatives will become widely popular only if litigants confront the psychological tendencies shaping their existing fee arrangements.

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[1] Eyal Zamir and Ilana Ritov, Revisiting the Debate over Attorneys' Contingent Fees: A Behavioral Analysis, 39 J. Leg. Stud. 245 (2010).

[2] Daniel Kahneman and Amos Tversky, Prospect Theory: An Analysis of Decision under Risk, 47 Econometrica 263 (1979). Professor Tversky died in 1996; Kahneman won the Nobel prize in economics in 2002. It is widely accepted that Tversky would have shared the prize had he been alive (the prize cannot be awarded to a deceased).

[3] This is the most common fee arrangement used at my firm. The arrangement allows for an outcome-based component of fees on both plaintiff- and defense-side cases.