Cheating Clients with the Percentage-of-the-Gross Contingent Fee Scam

W. William Hodes
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W. William Hodes*

I. INTRODUCTION: A BASELINE EXAMPLE OF A SCAM IN ACTION

I was pleased and honored to participate in the third of the magnificent series of national legal ethics symposia hosted every two or three years by the Hofstra University School of Law. The Symposium theme this year posed the question “What Needs Fixing?,” which I understood to have as its ever-so-slightly sardonic subtext, “What still needs fixing, even after publication of the Restatement of the Law Governing Lawyers,1 and even after completion of the work of the Ethics 2000 Commission?”2 I first became aware that one little piece of the regulation of attorney’s fees was broken one day in the fall of 1979,

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This Essay is an extension of remarks I made on the afternoon of September 11, 2001 at the Hofstra University School of Law Symposium Legal Ethics: What Needs Fixing? That the organizers of the Symposium decided to press ahead, even in the face of the terrorist attack that took place that morning in nearby Manhattan, is a small tribute—one of thousands we have seen in the intervening months—to the indomitable American spirit. I would like to thank the staff of the Hofstra Law Review, and especially Nancy Lucas, for assistance in putting the finishing touches on this Essay.

1. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS (2000). The final draft of this Restatement was approved by the members of the American Law Institute (“ALI”) at its May 1998 annual meeting, held in Washington, D.C. That action had been preceded by some thirteen years of drafting and debate, punctuated by annual votes on a series of tentative drafts. See id. at xxii. According to ALI practice, the reporters for a Restatement have discretion to make stylistic and technical alterations even after final approval; in the case of this work, this process lasted another two years. See STEPHEN GILLERS & ROY D. SIMON, REGULATION OF LAWYERS: STATUTES AND STANDARDS 465 (2001).

after Civil Procedure class during my first semester as a law professor at Indiana University. I have been tinkering away ever since, but it still needs fixing.

A first-year student approached me and wanted to know whether she had any recourse in the following situation. My student’s boyfriend had been involved in a moderately serious automobile accident, and, after a seemingly interminable delay, had just “won” a jury verdict of $60,000.

Acting pursuant to a written, and apparently otherwise valid, contingent fee agreement, the lawyer had awarded himself a one-third contingent fee of $20,000 off the top, which still left $40,000 for the client. Unfortunately, it had been necessary to obtain two expert medical reports and to take several short depositions of lay witnesses, for a total expenses bill of $45,000. This meant that the boyfriend owed the lawyer $5000, and the lawyer was demanding payment! A few more “wins” like this, and we are all undone. Except, of course, for the contingent fee lawyers.

3. See 1 GEOFFREY C. HAZARD, JR. & W. WILLIAM HODES, THE LAW OF LAWYERING, § 8.13, at 8-30 illus. 8-2 (3d ed. 2001). This illustration, which is loosely based on the same 1979 incident described immediately below in the text, has been included in every edition of the book, which was first published in 1985.

When the Ethics 2000 Commission began its work of suggesting revisions to the Model Rules of Professional Conduct, see supra note 2, I became a member of its Advisory Council. In what might be called a “targeted mailing,” I wrote to the Commission proposing an amendment to Rule 1.5, see infra note 5, along the lines suggested in this Essay. Later, in what might be called an “in-person solicitation,” I repeated this proposal at a public hearing held by the Commission in New Orleans. The Commission was unmoved by my advocacy, however.

4. I put the word “won” in quotes, because there is more to the story and more to the math (which has been simplified to protect the squeamish)—which is the whole point of this Essay.

5. Model Rule 1.5(c) reads, in pertinent part, as follows:
A contingent fee agreement shall be in writing and shall state the method by which the fee is to be determined, including the percentage or percentages that shall accrue to the lawyer in the event of settlement, trial or appeal, litigation and other expenses to be deducted from the recovery, and whether such expenses are to be deducted before or after the contingent fee is calculated.
MODEL RULES OF PROF’L CONDUCT R. 1.5(c) (2001) [hereinafter MODEL RULES] (emphasis added).

In 1979, of course, the Model Rules had not yet been promulgated by the ABA, much less adopted by any jurisdiction. The fee contract in question appeared to be in accord with DR 2-106 of the Model Code of Professional Conduct, however, which was in force in virtually all jurisdictions in the United States at the time. See GILLERS & SIMON, supra note 1, at 527. DR 2-106 did not require that contingent fee agreements be in writing, and did not advert to the matter of expenses of the representation and whether the calculation should be made on the net or the gross amount recovered. See MODEL CODE OF PROF’L RESPONSIBILITY DR 2-106 (1986) [hereinafter MODEL CODE].
I had never heard of such a calculation method before, and I had practiced law for some nine years before becoming a law teacher the year before. True, because most of my practice had been in government service and with a public interest law firm, I had not been personally involved in negotiating or setting attorney fees, but I understood—and assumed that everyone in the legal profession also understood—that the plaintiff had not “won” $60,000 at all. In reality, he had only won $15,000, once the legitimate costs of obtaining the gross amount of $60,000 were taken into account.

Of course, even a small win of $15,000 is better than losing, and certainly the lawyer would deserve compensation at the full 33 1/3% contract rate for investing his time and intellectual capital, while risking the full amount of that investment. Thus, continuing to assume a gross recovery of $60,000, but a true win of only $15,000, the expenses of the litigation would still all be paid to the providers, the lawyer would still receive a fee of $5000, and the client would be left with a net plus of $10,000. The difference between taking a fee of $5,000 and the $20,000 fee that the boyfriend’s lawyer actually took, every penny of which came out of the client’s hide, is what I refer to as the “percentage-of-the-gross contingent fee scam” that forms the title of this Essay.

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6. Under Model Rule 1.5(a), all fees must be “reasonable,” see MODEL RULES, supra note 5, R. 1.5(a), quite apart from the specific regulation of contingent fees set forth in Rule 1.5(c), see MODEL RULES, supra note 5, R. 1.5(c). Most authorities agree that a fee of one-third, while large, is ordinarily not “unreasonable” in the sense of Rule 1.5(a), because it takes into account the risk that the lawyer—and only the lawyer—bears of losing the professional time and effort he invested. See, e.g., Simler v. Conner, 282 F.2d 382, 384 n.30, 385 (10th Cir. 1960), rev’d on other grounds, 372 U.S. 221 (1963); Large v. Hayes, 534 So. 2d 1101, 1106 (Ala. 1988) (discussing 50% contingency as reasonable); Spinello v. Spinello, 334 N.Y.S.2d 70, 78 (Sup. Ct. 1972); see also Lester Brickman, Contingent Fees Without Contingencies: Hamlet Without the Prince of Denmark?, 37 UCLA L. REV. 29, 30 (1989) (“According to conventional wisdom virtually all contingent fee percentages exceeding fifty percent are illegal and excessive, but most lower percentages are valid.”). Although the general rule is as just stated, some courts have intervened where a nominally “reasonable” contingency fee rate generated a fee that in hindsight seemed “unreasonable” when compared to prevailing hourly fee rates. See 1 HAZARD & HODES, supra note 3, § 8.6, at 8-15.

7. Looking at the two methods of calculation from the client’s point of view, the difference is the same $15,000: the client “receives” either $10,000 or a negative $5000. As will be seen below, see infra note 32 and accompanying text, the difference is always the amount of the expenses multiplied by the contingent fee percentage. In other words, a lawyer employing the gross recovery calculation is effectively charging a “markup” on the expenses equal to the contingent fee percentage.
II. CALCULATING THE REASONABLENESS OF A FEE FOR LEGAL SERVICES—AMOUNT, METHODOLOGY, AND RATIONALITY

When I first heard of the percentage-of-the-gross contingent fee scam that first semester back in 1979, I was teaching the course in Professional Responsibility for the first time as well, and my Civil Procedure student may have been hoping to tap into my budding knowledge in the former field. What we today know as Rule 1.5(a) of the Model Rules of Professional Conduct ("Model Rules"), which prohibits lawyers from charging "unreasonable" fees, contingent or otherwise, was barely getting to the drawing board stage in 1979, but I was well familiar with the Disciplinary Rules ("DRs") of the Model Code of Professional Conduct ("Model Code"), which contained a similar prohibition in less elegant and more circular language. According to DR 2-106(A), a lawyer may not charge or collect a "clearly excessive fee," a term defined in DR 2-106(B). A fee was said by that paragraph to be "clearly excessive" when, "after a review of the facts, a lawyer of ordinary prudence would be left with a definite and firm conviction that the fee is in excess of a reasonable fee." DR 2-106(B) then provided a long list of factors suggesting how reasonableness might be measured by that hypothetical "lawyer of ordinary prudence," including factor (B)(8), "whether the fee is fixed or contingent." Unfortunately, no guidance was provided as to whether a contingent fee of a certain size ought generally to be considered more reasonable or less so than a fixed or hourly fee of the same size. Moreover, neither the DRs nor the Ethical Considerations ("ECs") associated with Canon 2 of the Model Code made reference to the method of calculation, or how expenses should figure into the equation at all.

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8. See MODEL RULES, supra note 5, R. 1.5(a).
9. See MODEL CODE, supra note 5, DR 2-106.
10. Id. DR 2-106(A).
11. See id. DR 2-106(B).
12. Id.
13. Id. DR 2-106(B)(8).
14. See id. Canon 2. As is well known, the Model Code had a tripartite structure: broad general "axiomatic" principles ("Canons"), aspirational and explanatory provisions ("Ethical Considerations" ("ECs")), and black letter rules ("Disciplinary Rules" ("DRs")). See Geoffrey C. Hazard, Jr., Legal Ethics: Legal Rules and Professional Aspirations, 30 CLEV. ST. L. REV. 571, 572 (1981). In theory, the DRs alone were legally binding minimum standards of conduct, enforceable in disciplinary proceedings, while the Canons and ECs served as organizing principles and interpretive guidelines, respectively. See id. In practice, however, it proved virtually impossible to maintain this separation. See id. at 572-73. For a critique of this structure by the chief draftsman of the Model Rules, which replaced the Model Code, see id. at 574, which argues that, while
In any event, while there has been considerable controversy over
the charging of contingent fees in situations presenting little risk of
nonrecovery, and while courts have often capped the permissible
percentage figure that may be used (usually by rule of court), and
sometimes have looked askance at the sheer size of the resulting fee,
there was little to suggest that the one-third contingent fee charged to my
student’s boyfriend was excessive or unreasonable in and of itself.

But the method of calculation—using the gross recovery rather than
the net recovery as a base—was another matter. From the moment I
heard my student’s sad tale, it occurred to me that the concept of
“reasonableness” of a fee must include an element of rationality or
appropriateness, even if the total amount is not unreasonably high by
conventional measures. What was shocking about the fee in question, in
short, was not that $20,000 was per se too high.

That proposition can be demonstrated by varying the facts only
slightly. Suppose that the lawyer had accepted the case with the same
one-third contingent fee agreement, and with the same clear risk of
achieving a zero recovery, thus losing the time he invested. But suppose
that, instead of litigating the case and incurring significant expenses, the
lawyer was able to convince the defendant to settle for the same $60,000
in a matter of a few weeks. Under those circumstances, the lawyer would
indeed be entitled to his full $20,000 fee, despite the possible objection
that he had actually performed less work to obtain it.

That objection would carry no weight with me, with most courts, or
even most academic critics because a genuine contingency existed, the

aspirational standards are desirable, they cannot coexist with binding legal rules in the same
document.

15. See Brickman, supra note 6, at 30-32, 84. In 1994, several academics, judges and public
officials, arrayed across a broad political spectrum, invited the ABA Standing Committee on Ethics
and Professional Responsibility to issue an opinion on the reasonableness of contingent fees in
situations involving little risk of nonrecovery, including situations in which an opposing party had
quickly offered a substantial settlement, so that there was no risk of nonrecovery at least as to that
in ABA COMM. ON ETHICS AND PROF'L RESPONSIBILITY, FORMAL AND INFORMAL ETHICS
response was severely criticized in Lester Brickman, ABA Regulation of Contingency Fees: Money
Talks, Ethics Walks, 65 FORDHAM L. REV. 247, 247–49 (1996), and Michael Horowitz, Making
Ethics Real, Making Ethics Work: A Proposal for Contingency Fee Reform, 44 EMORY L.J. 173,

16. See Brickman, supra note 6, at 113. For an excellent discussion of this development, see
Richard M. Bimholtz, Comment, The Validity and Propriety of Contingent Fee Controls, 37 UCLA
L. REV. 949, 958, 962, 973 (1990) (discussing issues such as interference with right to contract and
access to the courts as implications of both the First Amendment and the Due Process Clause).

17. See 1 HAZARD & HODES, supra note 3, § 8.6, at 8-15.
percentage figure of one-third is commonly used and within court-imposed guidelines in virtually all states, and the client had control over the decision whether to accept the proffered settlement or to push on to trial in the hope of obtaining more.  

In the actual case, the lawyer received the same $20,000 for doing more work, but in my view his fee was unreasonable nonetheless. This follows because the result he achieved was significantly worse, and in contingent fee arrangements—unlike hourly fee arrangements—lawyers are rewarded for results, not effort. The result achieved in the actual case was not “worse” as an abstract proposition, of course, because the defendant would write the same $60,000 check in either instance. But looked at in the real world and from the client’s point of view, the result was worse precisely because the lawyer obtained the same dollar figure while spending more of the client’s resources during the representation. In other words, to return to basic terminology, the lawyer obtained the same gross recovery, but a lower net recovery.

To allow the lawyer to receive the same fee as if he had achieved the same result without the expenditure of client resources is to reward inefficiency and to break apart the community of interests that the contingent fee is supposed to promote. Thus, percentage-of-the-gross contingent fees are unreasonable because they are irrational and because they promote bad policy, not because they are necessarily too large. Just as the law protects clients—somewhat paternalistically, it must be said—against fees that are excessively large, it should flatly prohibit the kind of mathematical scam that was played out against my student’s boyfriend, and thousands of clients after him.

18. Although the resulting hourly rate would be high, it would not be so high as to cause many courts to second-guess reasonableness after the fact. See supra note 6 and accompanying text. Moreover, given that there was genuine risk, and given that the total recovery and the resulting fee were all well within the range contemplated at the outset, probably even Professor Brickman and the other academic critics of contingent fees would not object either. See supra note 15 and accompanying text.

19. See, e.g., MODEL RULES, supra note 5, R. 1.5(a)(4).


III. **MEASURING RESULTS BY THE LAWYER’S “VALUE ADDED”**

The above discussion—to say nothing of my whole argument—brings into focus the fact that, from the client’s point of view, there is no clear divide between “fees” that will go into the lawyer’s bank account and “expenses” that go into the bank accounts of various third parties, such as court reporters, expert witnesses, or copy services such as Kinko’s. Instead, in the real world inhabited by real clients, what matters is how much the intervention or participation of the lawyer has improved the lot of the client at the end of the day. In short, leaving aside emotional wear and tear and other noneconomic risks and rewards of litigation, clients sensibly care only about the net results obtained by their lawyers, and consequently measure their satisfaction with the lawyers’ performance on that scale.

As indicated earlier, when I was asked in 1979 to assess the situation of a client subjected to a percentage-of-the-gross contingent fee, immediately available materials had little to say on the subject. The Model Code, which was in force essentially everywhere at that time, did not discuss or distinguish between fees and costs. There did not appear to be much case law either, perhaps because, by the late-1970s, not enough lawyers had yet had the brass to cheat their clients in this fashion. And the Model Rules, which would explicitly approve percentage-of-the-gross contingent fees, were several years away from final approval by the ABA House of Delegates, let alone the Indiana Supreme Court.

However, much later—namely, when I was preparing this Essay for oral presentation at the Hofstra Symposium—I discovered that the old 1908 *Canons of Ethics*, which had been replaced by the Model Code in 1969, did have something to say on the subject, but obliquely. Canon 12 listed some of the factors that ought to be considered in setting any fee—a list quite similar to the list now appearing in Model Rule 1.5. Item 4 on the old list was “the amount involved in the controversy and the

22. *See Lawyers Who Advertise Contingent Fees Must Explain Who is Responsible for Costs*, 17 Laws. Man. on Prof. Conduct (ABA/BNA) 484, 484-85 (2001) (citing Ohio State Bar Ass’n Legal Ethics and Prof’l Conduct Comm., Informal Op. 01-03 (2001), which held that a legal advertisement stating “[n]o attorney’s fee in personal injury cases unless we get money for you” is misleading because most nonlawyers are not aware of the distinction between fees and costs).

23. *See supra* note 5 and accompanying text.

24. *See supra* note 14 and accompanying text.

25. *See supra* notes 5-6 and accompanying text.


27. *Compare id*. Canon 12, with *MODEL RULES*, supra note 5, R. 1.5(a).
benefits resulting to the client from the services.” For the reasons given earlier, this can only refer to the net benefits the lawyer’s services have brought to the client.

In calculating the net value that the lawyer’s labors bring to the client, it is helpful to imagine that a contingent fee lawyer is keeping a ledger sheet for each client in each case. During the course of the litigation, contingent fee lawyers appropriately authorize or incur debits on the client’s ledger for necessary and reasonable costs and expenses. The cost of these expense items may be carried on the books of the provider, paid by the client, or advanced by the lawyer on the client’s behalf, which is the same as a loan to the client.

By the time the case is concluded, the lawyer hopes to have created a much larger credit, in the form of a judgment or settlement, which will extinguish the debits and leave the client with a net positive result. When the smoke clears, the client can enjoy only this net positive sum, and that sum is the proper measure of the value of the lawyer’s service to the client. This is what the 1908 Canons presumably meant by “benefits resulting to the client from the services,” which today we commonly

28. CANONS, supra note 26, Canon 12 (emphasis added).

29. In fact, most lawyers (or their bookkeepers) do keep ledger sheets of this kind, either in traditional ledger books or on one of the several software programs that have been developed especially for this purpose.

30. At common law, laws against “maintenance” prohibited either a lawyer or a third party from advancing living or other expenses to a litigant to enable continuation of the case. See, e.g., 2 HAZARD & HODES, supra note 3, § 54.4, at 54-6. In addition to traditional worries about “stirring up litigation” that would not otherwise be undertaken, a lawyer making this kind of loan to her own client in the very litigation that the lawyer is handling creates conflicts of interest that are causes for additional concern. See id.

Specific regulation of this form of conflict of interest has followed an uneven path of partial and shifting compromises, however. DR 5-103(B) of the Model Code continued the ban on advancement of living expenses, but permitted lawyers to advance out-of-pocket expenses of the litigation, “provided the client remains ultimately liable for such expenses.” MODEL CODE, supra note 5, DR 5-103(B) (emphasis added). If no such advances were permitted, it was feared that impecunious plaintiffs would not be able to withstand the financial pressures of even the most ordinary delay, thus giving defendants too much leverage in settlement negotiations. See ROBERT H. ARONSON & DONALD T. WECKSTEIN, PROFESSIONAL RESPONSIBILITY IN A NUTSHELL 276-77 (2d ed. 1991). On the other hand, if lawyers could advance litigation costs without limit, and without the client having to bear the downside risk, the traditional ills of maintenance might reappear. In practice, however, contingent fee lawyers who actually lost rarely insisted upon being repaid their investment: Although the client must remain “ultimately liable,” that did not mean that the lawyer was required to enforce that liability. See id. at 277.

Model Rule 1.8(e) is more liberal still. While advancement of living expenses during litigation is still prohibited, expenses of litigation may be advanced even if repayment is explicitly stated to be contingent on the outcome of the matter. See MODEL RULES, supra note 5, R. 1.8(e)(1). Moreover, in the case of an indigent client, the lawyer may make an outright gift of court costs and expenses. See id. R. 1.8(e)(2).

31. CANONS, supra note 26, Canon 12.
refer to as the “value added” by the lawyer. In my original example of the law student and her boyfriend, it would again be $15,000, not $60,000.32

In any event, assuming I am right that lawyers of my generation and earlier—those who graduated from law school during and after the mid-1960s, when there was a huge upsurge in the law school population—universally charged only on this basis, and thus calculated contingent fees only on the net amount recovered, it must have been during the late-1970s that contingent fee lawyers decided to give themselves a raise without telling anybody. Moreover, they must have had a good lobby, too. The Discussion Draft of the Model Rules, published in January 1980 (a full three years before final promulgation of the Model Rules) already included the version of Rule 1.5(c) that is in force in most jurisdictions today,33 endorsing percentage-of-the-gross fees and requiring only that the scam be announced in the fee agreement, not that clients be given a choice in the matter, or even that they be told why they should care.34

32. It is important to remember, however, that in calculating the net benefit to the client or the “value added” by the lawyer, the client is entitled to a credit against the gross recovery only for costs and expenses that were themselves made necessary by the intervention of the lawyer. Most particularly, if the client had preexisting expenses (such as unpaid medical bills) before the lawyer came on the scene, those would not be deducted before calculating the lawyer’s contingent fee, even in the percentage-of-the-net scheme that I advocate.

In the example of the boyfriend’s automobile accident, assume that, instead of $45,000 in litigation costs, there were no such costs but rather $45,000 of uninsured medical bills. In that situation, when the lawyer secured a $60,000 settlement or judgment for the client, the client would indeed suddenly be “better off” by the full $60,000, and the lawyer would be entitled to his full fee of $20,000. The client would have gained $40,000 from the case that the lawyer handled, although all of it and more will no doubt eventually wind up in the hands of the medical providers. But that is not the lawyer’s “fault”; rather, the lawyer’s efforts produced the money that the client was able to use to eliminate most of his existing debt—an obvious gain to the client.

Compare, however, Levine v. Bayne, Snell & Krause, Ltd., 40 S.W.3d 92 (Tex. 2001), in which a law firm was permitted to calculate its contingent fee only on the net “amount received” in a litigated matter after deducting a setoff of a preexisting debt. See id. at 94-95. This is a highly dubious result, as the dissenting justices pointed out, because not only was the client’s preexisting debt eliminated, but so also was a mortgage securing that debt. See id. at 102 (Hecht & Abbott, JJ., dissenting). Thus, in exchange for paying the debt, the client received the subject property free of the mortgage. See id. at 103 (Hecht & Abbott, JJ., dissenting). This effectively meant that the “value added” by the law firm was the entire original amount, because the set off amount was in turn off set by the value of the extinguished mortgage. See id. at 102 (Hecht & Abbott, JJ., dissenting).

33. Compare MODEL RULES OF PROF'L CONDUCT R. 1.6(d) (Discussion Draft 1980), with MODEL RULES, supra note 5, R. 1.5(c). For a discussion of selected state variations of Rule 1.5, see GILLERS & SIMON, supra note 1, at 49-57.

34. See MODEL RULES, supra note 5, R. 1.5(c).
IV. THE PRACTICAL EFFECT OF PERCENTAGE-OF-THE-GROSS CONTINGENT FEES—ILLICIT MARKUP OR USURIOUS LOAN?

In the mathematically sanitized real-life example described at the outset of this Essay that first alerted me to the percentage-of-the-gross contingent fee problem, the difference between the gross and the net methods of calculation of the fee came to $15,000. The lawyer’s fee was either $20,000 or $5000, and the client either gained $10,000 or owed $5000.

In this section, I pose and examine three linked sets of hypothetical (and distinctly contrived) figures, with an eye to demonstrating the direct mathematical relationship between the expenses incurred and the extra fee that the lawyer will earn using the gross recovery calculation (as opposed to the net recovery calculation). Along the way, I hope to show as well that the practical (and deleterious) consequences of adopting this method of calculating the fee do not depend upon whether the lawyer advances the expense money, whether the client pays each expense item as it becomes due, or whether the service provider is content to extend credit and receive payment for the expense in question at the end of the case.

Let us continue to assume a genuinely contested and therefore inevitably risky case—but one that is not even close to being frivolous. The contingent fee contract again calls for one-third of the recovery to be paid to the lawyer. In each example there is only a single expense item, each a legitimate expenditure that a competent lawyer might reasonably choose to incur or not to incur to advance the case, and each is exactly $3000. In the three hypotheticals, only the expense item and the manner of its payment differ, as described below. Finally, a settlement is ultimately agreed to in each case, calling for the plaintiff to receive the gross sum of $30,000.35

In the first example, the plaintiff’s lawyer decides to send each of a long series of negotiation proposals by Federal Express, in order to impress the other side with her seriousness of purpose. The lawyer has

35. It is certainly a contrivance to assume that there will always be a recovery, let alone that the recovery will always be exactly $30,000. Accordingly, I pose three parallel hypotheticals in which the expenses are as stated in the main hypotheticals, but there is no settlement, no recovery at trial, and also—to keep the math simple and uniform—no additional expense. In all of these cases, the expense bill will have to be paid or carried by someone, and the question will be whether the lawyer or the client will bear the dead loss of $3000. This feature of real-life litigation is of great practical concern, but because the lawyer can either choose to accept this risk of loss or insist at the outset that only the client bear this risk, it should not affect analysis of the legitimacy of charging extra on account of costs.
no interest in Federal Express, secret or otherwise, the company charges its normal rates, and the lawyer pays the $3000 in charges as they are billed. This is a most common method of handling ongoing expenses, and it is understood that the client is ultimately responsible for these charges that have been incurred on his behalf and will reimburse the lawyer for them.\footnote{36}

Second, the lawyer recommends hiring an expert in the field to evaluate the case, for which the expert charges a flat fee of $3000. The plaintiff client, who is meticulous in keeping track of expenses in all of his business and other affairs, pays this sum by personal check the day

\footnote{36. It should be remembered, however, that, under Model Rule 1.8(e), the client \textit{may not} actually have to repay these costs, if there is no recovery. See \textsc{Model Rules}, \textit{supra} note 5, R. 1.8(e); see also \textit{supra} note 30 and accompanying text. Indeed, even under the provisions of the Model Code, although the client had to remain "ultimately liable" for expenses advanced by the lawyer, in practice many lawyers would not insist upon enforcing that liability. See \textsc{Model Code}, \textit{supra} note 5, DR 5-103(B); see also \textit{supra} note 30 and accompanying text. Accordingly, lawyers advancing costs are often putting those costs at risk, in addition to risking the cost of their intellectual capital, which is always a factor where the contingency is a genuine one, as assumed in all of the hypotheticals under discussion. This additional risk factor is sometimes advanced as a justification for charging percentage-of-the-gross contingent fees, but it will not bear the weight.

First, the contingency factor has already been built into the fee aspects of the arrangement so that the typical contingent-fee lawyer will earn enough in successful cases to balance out losses of both time and un-recouped expenses in losing causes. Certainly, the extra risk is insufficient to justify marking up the \textit{expenses} in successful cases a full 33\% or more, which is the effect of percentage-of-the-gross contingent fees, as demonstrated below in the text. Second, although the contingency factor is a legitimate one, its significance is often overplayed, even with respect to fees. Lawyers are not in the habit of accepting marginal cases, even where advances for costs will be small, because the risk of losing the time invested, which is always present, already serves as a strong negative check. Third, and perhaps most important, there are alternative ways for lawyers to shift the risk of loss of cost outlays back to the client, which is where it ultimately ought to reside in any event, as previously noted. A lawyer already wary of accepting a particular contingent fee case may, for example, be persuaded that the extra risk of losing out-of-pocket costs is enough to tip the balance toward simply declining the case. (The client may then be able to find another lawyer, who has more faith in the merits of the case, or enough ready cash to be able to risk losing some of it in exchange for the chance at a fee.) Or a lawyer may accept the case on the stated condition that she \textit{will not} agree to advance the costs of the case; in that event, the client might be able to borrow the money from friends or family, possibly without interest, or the lawyer might help the client obtain a loan from a financial institution at market or premium rates—in which case the interest charged to the client will \textit{still} be far less than 33.33\%! Still another possibility is that the lawyer will agree to advance costs on the client’s account, but insist—and so state in advance—upon recouping them whether or not there is a recovery.

It is true that, even after these alternative sources of funding the costs of litigation are exhausted, some clients still will not be able to afford to risk failure to recover even enough to recoup those costs. The hard reality in such cases is that the client, who has already been offered an advance of legal services at no risk, will simply not be able to bring the claim. But if the claim, even though not frivolous, is sufficiently dicey not to be able to attract any funding on any of the above bases, it is probably a good thing overall that it languish on the vine.
after the expert issues her report. Third, the lawyer arranges for a series of long negotiation sessions to be held in her office to try to hammer out a deal; a local luncheonette sends in tuna fish sandwiches costing a total of $3000. The lawyer has no interest, hidden or otherwise, in the luncheonette, and the total sandwich bill is a reasonable one. In this third example, the third-party provider simply adds the total to the law firm’s running account instead of receiving payment for each order. When the case is finally settled, the $3000 bill is still outstanding, but it is paid shortly thereafter.

In all three of these variations, no matter who actually pays the $3000 expense bill, and on what schedule, the service provider is always satisfied out of the proceeds of the settlement, leaving $27,000 out of the $30,000 gross settlement for the lawyer and the client. The lawyer will earn a fee of either $10,000 or $9000, depending on which method of calculation is used, and the client will then walk away with $17,000 or $18,000, as the case may be. In each of these hypotheticals, therefore, just as in the real-life original example, the difference (here $1000) is precisely one-third of the expense bill (here $3000).

37. As described below in the text, in the net recovery method of calculation that I advocate, the client must be reimbursed out of the settlement proceeds before the lawyer’s one-third share is levied. Some have objected that this means that the lawyer is “paying” one-third of the client’s expenses, or that the lawyer is “sharing” in them to the extent of one-third. This is mathematically accurate, but only in comparison to what the lawyer would earn if one-third of the gross were the assumed baseline, and the lawyer was suffering a “reduction” in compensation.

That is the wrong baseline to use, however, as I have argued throughout this Essay. Moreover, the instant example is the best one to demonstrate the fallacy of the suggested line of argument because it shows that the lawyer is proposing to take an unjustified additional fee in the amount of one-third of the expenses, not a reduction. To see why this is so, consider that if the client is not given credit for the $3000 paid out of his own pocket, the lawyer will receive a full third of the gross settlement of $30,000, which is the same sum the lawyer would receive if there were no expenses at all! Thus, the lawyer would receive an enhanced fee in exchange for no extra risk of loss of the expense money, and merely for the privilege of watching while the client spent money that the lawyer urged him to spend. Meanwhile, the client, who properly pays the $3000 in expenses in all variations, pays the lawyer an additional $1000 for no apparent reason.

38. See ABA Comm. on Ethics and Prof’l Responsibility, Formal Op. 93-379 (1993) [hereinafter Formal Op. 93-379] (finding it unethical for lawyers to create extra “profit centers” by passing on to clients more than the dollar-for-dollar cost of disbursements related to the representation), reprinted in ABA ETHICS OPINIONS, supra note 15, at 216, 223. “The lawyer’s stock in trade is the sale of legal services, not photocopy paper, tuna fish sandwiches, computer time or messenger services.” Id. at 224. See also LAWRENCE J. FOX, JUST DESERTS, in LEGAL TENDER: A LAWYER’S GUIDE TO HANDLING PROFESSIONAL DILEMMAS 227 (1995), for a short story written by a member of the Committee when Formal Opinion 93-379 was issued. In this story, a newly hired lawyer in a law firm that is evidently the real Hell is shown a series of lawyers doomed to suffer punishments fitting the “crimes” of their earlier billing practices, each of which had been condemned in the opinion. See id. at 230-36. One of the unfortunates is observed complaining loudly in the cafeteria that he was being charged extra for his silverware and a straw. See id. at 233.
If one compares these three situations with a fourth, in which there are no expenses, it is apparent that using the gross recovery calculation is exactly the same as if the lawyer had charged a markup on the expenses bill of exactly 33 1/3%, which is the contingent fee percentage. Furthermore, the client who receives a disbursement check of $17,000 will not have a clue that, but for this markup, the check would have been larger by $1000. Clients who do not know they have paid $1000 extra to the lawyer merely because the lawyer thought it wise to spend $3000 of the client’s money will, of course, never complain—which is exactly the way the lawyers like it, and why they never explain the significance of the calculation method, or even that there is more than one way of doing the calculation.

V. TINKER, TAILOR, LAWYER, CHEAT: COST-PLUS BILLING AND THE FIDUCIARY RELATIONSHIP

In many service industries, a standard method of charging fees is cost-plus billing. The professional providing services to the customer or client purchases the necessary materials (sometimes including the labor of subcontractors), and then adds a fixed percentage markup to cover overhead, administration, and profit. Tinkers and tailors may use this billing method, and when a waiter serves a large party in a grand restaurant, the gratuity is often calculated in advance based on a set percentage.

The same principle is at work in all commission sales transactions, although we do not normally think of the transaction as involving a series of component parts, each one separately priced and marked up.

39. A markup on expenses was one of several billing practices found to be unethical in Formal Opinion 93-379. See Formal Op. 93-379, supra note 38, at 216-17, 223. Moreover, in the examples considered in the opinion, the markups did not even approach the typical contingent fee rates of 25%, 33%, or even higher. See id. at 218.

40. It is important to recall that, in all of the examples given in this Essay, I am assuming that the lawyer’s judgment was sound and was not infected by self-interest. The problem is not that the lawyer spent the client’s money or advanced money that the client would later repay; it is that the lawyer charged an exorbitant “service fee” of one-third for doing so.

41. See Formal Op. 93-379, supra note 38, at 217 (noting that “the bases on which the charges are to be assessed often are not disclosed in advance or are disguised in cryptic invoices so that the client does not fully understand exactly what costs are being charged to him”).


43. See id.

44. See id. Accordingly, if you order wine that is twice as expensive, that portion of the service fee will double, even though the pouring motion is the same and the cork is just as easy to extract.

45. See id.
Thus, if you buy twice as much stock, the cost of the broker’s service doubles (leaving aside quantity discounts), and the same is true of automobile and real estate sales. But perhaps the most telling example, where there is both a final product and a series of interim cost-plus transactions, is that of a contract for building a home.\textsuperscript{46}

Suppose that my contractor is putting the finishing touches on my new home, working on a 10\% cost-plus markup. At the last minute, just as the plumbing fixtures are about to go in, my contractor calls and recommends that I switch from brass faucets to solid gold, but only in the master bathroom. The additional cost of the faucets is $1000, which means that I will pay $1100 extra for going in style. Already worried about overspending my intended budget, I argue that, although the gold faucets are indeed impressive and worth every extra penny, it is unreasonable for me to pay an extra $100 for the installation. After all, the contractor can pick them up from the same supplier, and it will take not even a minute more of her time to install them.\textsuperscript{47}

The contractor, however, is unlikely to be moved by this line of reasoning. She will point out that our deal was cost-plus, and that I had the choice of whether or not to purchase a pricier set of faucets at the last minute. I will derive more pleasure from the more expensive end product, it is true, but only I can decide whether the additional enjoyment is worth every dollar of the extra cost, and the extra cost is $1100, not $1000. She will also say that the end result of her labors—with the gold faucets included—is going to be a slightly more valuable home that will have a slightly higher resale value. She is thus guaranteeing me a superior result and demands payment according to our agreement.

There are several reasons, it should be obvious, why a lawyer cannot be permitted to use the same argument to justify cost-plus pricing with respect to specific cost items, even if they will probably contribute to a superior final result. First, perhaps, is the very word “probably” in the preceding sentence. Although all of the lawyer examples considered so far have assumed that the lawyer recommended the expenditures in question in good faith, meaning that the client can properly be debited for those amounts, there is no one-to-one relationship, or even a direct

\textsuperscript{46} See 2 ACCOUNTANTS’ HANDBOOK § 24.6, at 35 (D.R. Carmichael et al. eds., 8th ed. 1996).

\textsuperscript{47} This is a real story, just like the story about contingent fees set out at the beginning of this Essay. But, again, the facts and figures have been modified to make the point easier to follow. There are no gold faucets in my home, and I have suppressed any memory of what the contractor’s actual markup was.
causal relationship, between the expenditure and a superior result. In
other words, if a home owner purchases gold faucets, the “net” result
will be a more elegant home, whereas if a litigant purchases mediation
services or tuna fish sandwiches necessary to sustain a day-long
negotiation, there is no guarantee that these will not be dead losses.

Second, and more important, is simply the point made in ABA
Formal Opinion 93-379: Lawyers are not in the business of selling
anything other than legal services, especially on a commission basis.48
Indeed, if they do provide these “extras,” they are ethically required to
provide them at cost, not cost-plus.49 By contrast, customers of
homebuilders are perfectly aware that the builder is not only selling the
service of assembling a home from all of the component parts, but is
also in the business of selling each component part on commission. The
third difference, which follows from the second, is that, because of these
different expectations, consumers of a builder’s services (but not a
lawyer’s) can protect themselves against overselling. In other words, the
homeowner can judge the builder’s recommendations with the
appropriate level of skepticism; conversely, the client will not even be
aware of the lawyer’s self-interest under the percentage-of-the-gross
calculation method.

It is no doubt true that most contractors have a genuine pride in
craftsmanship and will usually recommend more expensive items in
good faith because they will be beneficial to the consumer, just as I have
assumed throughout this Essay that the lawyers in the examples have
recommended only cost items that they believe in good faith will
advance the client’s cause. The fact remains, however, that contractors
have a direct financial stake in including more, rather than less,
expensive items in each room in the house, and the owner will be well
advised to keep that fact in mind when approving change orders. Under
the gross-amount calculation method, lawyers also have a direct
financial stake in spending more, rather than less, on a client’s matter,
but clients who are unaware of this fact are correspondingly disabled
from taking it into account.

Finally, the most important and the simplest difference between
homebuilders and lawyers is that the latter, almost uniquely among
service providers, are fiduciary agents of their clients at the same time.50
Thus, if a contractor sells an extra gold faucet or two to a vainglorious

49. See id. at 216-17, 223.
50. See id. at 220 (“[T]he attorney-client relationship is not necessarily one of equals . . . it is
built on trust, and . . . the client is encouraged to be dependent on the lawyer . . . .”).
homeowner, or if an automobile salesman sweet-talks a shortsighted customer into purchasing more car than the budget will realistically allow, there is social harm, to be sure, but there is no disloyalty or betrayal, because these service providers deal at arm’s length with everyone and do not (seriously) profess otherwise. But if a lawyer acts against the interests of a client, especially without disclosing a conflict of interest, that is a betrayal of the defining element of the entire client-lawyer relationship, which is supposed to be trust. After all, lawyers profess loudly—and have written it into their professional rules of conduct—that they deal at arm’s length with everyone except clients, with whom they deal as fiduciaries.51

Thus, at bottom, the percentage-of-the-gross contingent fee should be deemed per se unreasonable for an ironic reason indeed. It is literally "unlawyerlike" to cheat clients by marking up costs of the litigation without telling them, despite the fact that so many lawyers do it.

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51. See, e.g., MODEL RULES, supra note 5, R. 1.8(a) (business transactions with clients); R. 1.8(c) (gifts from clients); R. 1.8(d) (exploitation of media rights to client’s story); R. 1.8(f) (third-party payment of client’s attorney fees); R. 1.8(j) (acquisition of proprietary interest in client’s claim).