BY DOUGLAS FITZPATRICK

Contingent Fees in Early Settled Claims

Does the System Need Reform?

The contingent fee system is under scrutiny in a number of states. There, a proposal is on the table to limit fees in claims that settle early.[1] A case can be made that the scrutiny is justified and that the proposed reform has merit.

Arizona was among 12 states in which petitions were filed to amend the ethical rules to address the issue of contingent fees in early settled cases. On Oct. 7, 2003, the Arizona Supreme Court denied the petition without comment. In so doing, Arizona became the first state to act on the reform measure.

The Court's denial was a missed opportunity to put the public interest ahead of the self-interested concerns of the bar.[2] The rule change would have drawn a line between large fees and excessive fees in early settled cases. It also would have gone a long way toward leveling the playing field between attorneys and their clients.

Inviting Ethical Violations

In the Matter of Swartz[3] shows how our contingent fee system invites ethical violations in claims that settle early. In *Swartz*, the client was seriously injured when hit by a car. He sustained severe multiple injuries. The client, Steven Sarge, was on the job when injured, and he received worker's compensation benefits. The industrial carrier that paid the benefits had a statutory lien against the recovery.

In Sarge's tort claim against the motorist, there was no question about who was at fault. The driver was covered by two separate liability policies with limits of $50,000 and $100,000. Shortly after Sarge retained Swartz on a one-third contingent fee basis, one of the liability carriers turned over its $100,000 policy limits. About two months later, the second carrier turned over its $50,000 policy limits.

The time demands on Swartz in settling the claim were minimal. Of the $150,000 obtained by Swartz, he took $50,000 as his fee. The industrial carrier that paid the worker's compensation benefits received most of the remaining $100,000 by virtue of its statutory lien. Sarge got nothing.

The Arizona Supreme Court concluded that the one-third contingent fee was excessive. The Court reasoned that, in light of the clear liability of the motorist who injured Sarge, there was no contingency. There were no difficult problems in the case. In obtaining the $150,000 settlement, there were no significant demands on Swartz' time. The Court thought it was significant that Swartz didn't have to file a lawsuit. The Court observed that, although contingent fee agreements are often proper when contracted, they may turn out to be excessive: "We hold, therefore, that if at the conclusion of a lawyer's services, it appears that a fee, which seemed reasonable when agreed upon, has become excessive, the attorney may not stand upon the contract; he must reduce the fee."[4]

What's Reasonable?

So the Court ruled in *Swartz* that contingent fees in early settled cases should be reviewed by the attorney for reasonableness. That is easier said than practiced.

Consider the following hypothetical claim.

In the first meeting, I learn that my

client has been rear-ended in an automobile accident.

- He was properly seat-belted and simply sitting in traffic at the moment of impact.
- There are no liability issues or claims involving nonparties.
- There is $100,000 in liability coverage to pay the claim.
- My client has incurred $20,000 in medical bills to treat a soft-tissue injury and a broken wrist. His damages include $3,000 in lost wages.
- My client presents himself well and has no skeletons in the closet or history of preexisting conditions to muddy the waters.
- He has fully recovered without any impairment or residual symptoms.
- More important, he simply wants to settle the claim for what's fair and will follow my lead in evaluating the claim.

I know when my client signs the standard 30 percent contingent fee agreement that this is a claim that will settle easily and without a lawsuit for at least $50,000. After 27 years in the practice of law, I know that the process by which records are gathered and a demand package assembled is mechanized. From initial client contact through negotiation of the settlement check, I'm going to spend 5 to 10 hours.

Sure enough, after making a demand for $75,000, an offer is made for $50,000. With my assurance that the tender is reasonable, my client accepts the offer. The adjuster forwards the release and check, and I determine that there are no liens against the recovery.

The math by which my fee is calculated is simple. Thirty percent of $50,000 is $15,000. I've spent five hours from the initial contact with my client through execution of the release and negotiation of the settlement check. The only obstacle to a $15,000 fee for five hours' work—ER 1.5[5] and *Swartz*.

Unbeknownst to my client, ethical and moral constraints compel a fee reduction to an amount that is reasonable when literal enforcement of the fee agreement would result in payment of an excessive fee.[6] Because I am uneasy about the size of the fee, I discount it by several thousand dollars. Although my conscience won't allow me to take $3,000 per hour in a claim that has cost me little and where there's been no risk, I can feel that I've done my part in acting ethically if I discount the fee to $10,000.

At some point along the path toward settlement, I explain to my client that, even though he's expecting to pay a fee of 30 percent of what's been recovered, I have determined that a fee reduction is appropriate.

Do I review the ethical nuances of *Swartz* and ER 1.5 or confess that the size of the discount I've determined to be reasonable is, in large measure, arbitrary? No. I leave the client with the impression that I've discounted my fee because I am a generous fellow.

Where might the dialogue lead if I told him that I was ethically obligated to reduce my fee? Would he ask why the issue of early settlement wasn't covered in the fee agreement? Or worse yet, might he ask how I arrived at the size of the discount?

Protecting and Informing Clients

For years, I represented claimants under the same contingent fee arrangement that provided I was entitled to 30 percent of the recovery whether or not the claim settled early and easily and whether or not I undertook such representation without any risk of nonrecovery. It was as if ethical considerations that might compel a fee reduction were none of my clients' business.

I've seen similar contingent fee agreements from many other lawyers. They are variations of the same theme: The baseline contingent fee is 30 percent of the recovery. As the claim ripens into a filed complaint, the fee increases to 35 percent or 40 percent. As the case proceeds to trial, the percentage escalates. There is no slid-

ing scale in the other direction by which the fee is lower for claims that settle early and with no risk of nonrecovery.

If we rationalize the injustice long enough, we become desensitized to its adverse impact on the clients to whom we have a fiduciary duty. If I can earn $15,000 in five hours in the routine fender bender, what are the ethical implications in a claim that settles early and easily for $500,000?

In the context of claims that settle early, the present system raises some difficult questions.

- Do ER 1.5 and *Swartz* really protect clients from overreaching attorneys and excessive fees when clients have no way to know that such safeguards exist?
- How would the client know of the protections afforded by ER 1.5 when they're not addressed in the fee agreement?
- Why would an attorney not charge a full contingent fee without concern for a bar complaint if the client is satisfied that the attorney is not taking anything not contemplated by the agreement?
- If the attorney feels compelled to discount the fee, why is the size of the discount left to the unfettered discretion of the attorney?

Return for a moment to the fictitious client described above. What would happen if 100 attorneys were asked the following questions about the claim:

1) Should the attorney discount the contingent fee? Is a $15,000 fee for five hours of work excessive? Or was this simply a good case that enabled the attorney to earn a large fee?
2) If the fee should be reduced, how is the size of the discount determined?

It is highly unlikely that all of the attorneys in the test group would agree that a fee discount is necessary. Of the attorneys who believe a fee discount is appropriate, chances are slim to none that there would be any consistency concerning the amount

of the fee reduction each would feel compelled to make.

What the Client Knows

When a client enters a contingent fee agreement, he or she knows only what is reflected in the agreement. If there are ethical rules that affect the rights or obligations of the attorney or the client, it is unlikely that the client would be aware of them. For instance, the client has no way to know that the attorney's fee must be "reasonable" and that "reasonable" may mean something other than what is in the agreement. Neither would the client have reason to suspect that the agreed-upon contingent fee could result in payment of an excessive fee.

ER 1.4(b) provides, "A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."[7] Nonetheless, attorneys don't commit in advance to reasonable discounts from the standard 30 percent contingent fee for claims that settle early and without risk or substantial demands upon the attorney. The attorney's failure to disclose such ethical duty violates ER 1.4(b). It is unlikely that many, if any, attorneys incorporate their ethical duty with regard to contingent fees in their fee agreements.

A Reform in Practice

In a number of states, amendments to the ethical rules are under consideration that would limit contingent fees in claims that settle early.[8] The concept being advanced would limit contingent fees to 10 percent or 15 percent of the recovery in claims that settle early and with little demand on the time or resources of the attorney. Failing an early settlement, the attorney would be free to represent the client under any fee arrangement that comports with ER 1.5 and the ethical constraints espoused in *Swartz*.

About two years ago, I incorporated into my own practice and contingent fee agreement the simple concept that is at the heart of the pending reform effort. My client and I agree that if the claim settles early, easily and without the need to file suit, my contingent fee will be 15 percent of the recovery. If litigation is necessary, the fee is 30 percent. Here is what I've learned:

1. Having disclosed to my client the impact of an early settlement on the size of my fee, I have avoided a violation of ER 1.4(b).
2. I don't have to be concerned about a finding that my fee agreement is unenforceable because I failed to disclose material facts in entering it.
3. I have assurance that I have complied with ER 1.5. By commitment to a predetermined lower contingent fee, the mystery has been taken out of the concept of "reasonableness" as it relates to fees in early settled cases.
4. The lower contingent fee gives the client a reason to settle early.
5. Early settlement is promoted, and the client receives a greater share of the settlement.
6. Liens against the recovery are more easily compromised. Lien claimants are more generous when dealing with attorneys who are reasonable with their fee. Reduced liens also mean a greater share of the recovery ends up in the pockets of the client.
7. Commitment to a lower contingent fee in early settled claims does not mean a less profitable practice. What attorney would not rather have 15 percent of a reasonable early settlement than 30 percent of a claim that must be litigated?

My client and I agree that if the claim settles early, easily and without the need to file suit, my contingent fee will be 15 percent of the recovery. If litigation is necessary, the fee is 30 percent.

Most attorneys are unwilling to acknowledge that the traditional contingent fee system invites ethical violations in such claims. For many, the status quo is just fine because it allows the attorney to control the distribution of settlement funds and the size of the fee. If lawyers perceive the reform effort as an unnecessary restriction on the right of an attorney to contract with his client, rather than the solution to a huge problem, change will come slowly. In the meantime, clients will continue to be overcharged and treated arbitrarily in claims that settle early and easily.

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endnotes

1. Under the proposed rule, when an injured person retains an attorney on a contingent fee basis, the attorney must provide written

notice sufficient to allow the allegedly liable party to assess the claim. If a defendant makes a settlement offer within 60 days of the required notice (which must be kept open for a period of at least 30 days), and the injured person accepts that offer, the attorney may not charge a fee that exceeds 15 percent of the recovery. If the attorney does not provide that notice, the attorney may charge only an hourly fee that does not exceed the limits described above, regardless of how the case concludes. Because some cases that settle early may require more work than others, counsel may always petition a court to increase the permissible fee beyond the limits in the rule.

The proposal does not require a party to make or accept an early offer, and the proposal will have no impact if no offer is made or accepted. In such cases, the arrangement between injured parties and their counsel will be governed by the fee agreement in place, subject to Rule 1.5's requirement of reasonableness.

2. Preamble to Arizona Rules of Professional Conduct: "The profession has a responsibility to assure that its regulations are conceived in the public interest and not in the furtherance or parochial or self-interested concerns of the bar."
3. 686 P.2d 1236 (Ariz. 1984).
4. *Id.* at 1243.
5. (a) A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses. The factors to be considered in determining the reasonableness of a fee include the following:
   (1) the time and labor required, the novelty and difficulty of the questions involved, and the skill requisite to perform the legal service properly;
   (2) the likelihood, if apparent to the client, that the acceptance of the particular employment will preclude other employment by the lawyer;
   (3) the fee customarily charged in the locality for similar legal services;
   (4) the amount involved and the results obtained;
   (5) the time limitations imposed by the client or by the circumstances;
   (6) the nature and length of the professional relationship with the client;
   (7) the experience, reputation, and ability of the lawyer or lawyers performing the services; and
   (8) the degree of risk assumed by the lawyer.
6. *Swartz*, 686 P.2d at 1243.
7. *See also* RESTATEMENT (SECOND) OF THE LAW OF AGENCY §381 (1958): "An agent is subject to a duty to use reasonable efforts to give his principal information which is relevant to the affairs entrusted to him."
8. *See supra* note 1.