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Litigation

MONEY MATTERS

Fee-shifting clauses don't always produce intended results • BY DAVID A. DEGROOT

Contractual fee-shifting clauses are usually intended to discourage litigation and encourage settlement. In many instances, these clauses have that effect.

However, these same clauses can also become an obstacle to the resolution of disputes. Cases can drag on for months or years due to claims for attorneys fees based on contractual fee-shifting clauses. If costs spiral beyond the value of the matter at hand, parties can find themselves in the unenviable position of not being able to settle their case and litigating over issues that have nothing to do with the merits of their underlying dispute.

Given that, how can these clauses be improved to help facilitate settlements? Before answering, it's helpful to take a look at how these clauses affect the resolution of cases.

If everybody saw the world the same way, all cases would settle. Instead, cases often do not settle or take a long time to settle because parties differ in how they value their case. There are three elements to case valuation: information, analysis and risk preference. The further apart that parties are in each of these elements, the less likely they will come to valuations that overlap and allow for settlement. Looking at litigation within this framework makes it easier to see how fee-shifting clauses can affect settlement.

It is no surprise that parties typically possess different information about their cases. When there is a large gap between what each party knows, cases become more difficult to settle. Discovery, of course, allows each side to glimpse the other side's story. Even if the parties don't agree on the facts, just knowing what facts an opponent has narrows the information gap. And when the parties more or less each know the same thing, cases become easier to settle.

In cases where parties more or less agree on the facts, settlement can still be elusive if the parties take very different views of the meaning of those facts. Two parties can come to different conclusions about the value of a case based upon the same facts for a number of reasons. Foremost among these reasons is bias. Parties, along with their attorneys, tend to evaluate cases more favorably to their own position rather than their opponent's position in part because they are biased toward themselves. Mediation can reduce analytical asymmetry by giving parties a reality check on the merit of their own analysis of a case, again reducing the distance between the parties.

Opposing parties can also have different risk preferences. Some may have strong preferences for certainty. Others may be risk-neutral. Still others may be risk-loving, such as where a party has more to gain from a good result than it has to lose from a poor one. The further apart the risk preferences of parties are, the less likely a case is going to settle. Thus, even if two parties have the same information and evaluate the case in the same way, a settlement may not be possible. That is because one party may value its positive outcomes so much more than it fears a negative outcome that its settlement value is simply too high or low for the other party to accept.

Rather than altering this framework, fee-shifting raises the stakes and affects how parties act in response to their risk preferences. Under our system of litigation, each side will expend money to litigate its case. As a result, money that will be spent to carry litigation of a case to verdict becomes a sunk cost — a cost that has been paid and cannot be recovered. Under this system, both sides gain something by ending the litigation: Each will not have to pay its attorneys any more once the case settles. With fee-shifting, winning is better and losing is worse. In terms of settlement, a party evaluating its case at settlement must also weigh giving up the opportunity to recover its fees against the possibility of being stuck with the other side's lawyer's bill as well as its own.

The contrast between the incentives under the American rule and under mutual fee-shifting is best shown by how it can affect the gap between the parties' case valuations. Ultimately, if that gap is not bridged, the case is not likely to settle.

Without fee-shifting, the best-case outcome of any case is the best possible litigated result minus attorneys fees. For example, take the case where the plaintiff's best result is a $100,000 verdict and that each side will spend $30,000 to litigate the case to verdict. The plaintiff's best net result is a $70,000 gain while its worst is being down $30,000. For the defendant, the best result is being down $30,000, with the worst being out $130,000. Assuming that the defendant does not care whether his lawyer or his opponent gets $30,000, this "nuisance value" can immediately become part of a compromise. Now, the gap between each party's best-case scenario is only

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$40,000. The parties don't have to move much closer together in terms of what each knows about the facts, how each evaluates the facts and the law, or how much risk is tolerable to bridge a gap of this size.

With fee-shifting, the best-case outcome is a full-value verdict (or a defense verdict) and getting your opponent to pay all of your fees. In the hypothetical described above, the plaintiff's best-case result is now $100,000 (biggest award, with the loser paying attorneys fees). The defendant's best-case result is zero.

The difference between these two scenarios is a $40,000 gap in expectations as opposed to a $100,000 gap. The larger gap can be harder to bridge, particularly if the parties are not risk-averse.

If each party is biased toward the prospects of its own case, that bias amplifies the effect that fee-shifting has in making a settlement harder to achieve. Take, for example, the $100,000 case where each party concludes that it has a 75 percent chance of prevailing and each party is risk-neutral. In that instance, the settlement value of the case is $25,000 for the defendant and $75,000 for the plaintiff. However, if each party is going to spend $30,000 to litigate the case to a result and there is no fee-shifting, the settlement value should be $55,000 for the defendant and $45,000 for the plaintiff. A case like this should always settle even though each side thinks that it will win three times out of four.

With fee-shifting, settlement becomes more difficult in this situation. Assuming each party is biased in favor of its own prospects (and, importantly, assuming each is risk-neutral), each will value the prospect of recovering its fees more highly than the prospect of having to pay its opponent's fees. The optimistic plaintiff thinks it has a 75 percent chance of a net recovery of $100,000 and only a 25 percent chance of paying $60,000 in fees for itself and the defendant. The settlement value for the plaintiff is now $60,000 (75 percent of $100,000 minus 25 percent of $60,000). The similarly biased defendant believes it has only a 25 percent chance of losing. If so, it would lose $100,000 in damages plus $60,000 in fees. The defendant's settlement value would be $40,000 (75 percent of no net loss, because fees are shifted, plus 25 percent of $160,000).

Parties and litigators, to be sure, often overrate their prospects in a case. Under the American rule, parties can completely disagree about their chances of success and still settle because both sides gain from not having to pay attorneys fees. With fee-shifting, parties have to come closer in their settlement evaluations to get closer to settling.

Risk preference is an important factor, too. If parties are risk averse, fee-shifting will encourage settlement. This is because a party will be more eager to avoid the bad outcome (losing *and* paying fees) than the great outcome (winning *and* getting fees). However, fee-shifting can result in cases that are harder to settle when the parties prefer risk. A party that "knows I'm right" is actually rewarded for pursuing his perceived vindication. Such a party may not experience litigation fatigue the way that a party with no hope of fee-shifting might. Similarly, a judgment-proof plaintiff whose lawyer hopes to get paid with the defendant's dollars through fee-shifting has additional upside and no downside from fee-shifting.

If the purpose of fee-shifting is to discourage disputes and encourage settlement, it is worth identifying the situations in which it will work as intended.

A contracting party that is confident that it will prevail in most disputes is likely to want a fee-shifting clause. A bank that loans money is a good example. Most of the time, it delivers the money at the time of contracting. And most of the time it will be a borrower who will breach the contract. When such disputes arise, it's likely that both parties will recognize the bank's high likelihood of prevailing and that fee-shifting will discourage "nuisance value" litigation. Lenders are also a good example of a risk-neutral party in that they probably have enough litigated matters so as to spread the risk of a bad result in one case over many cases.

Parties with few assets and those who must rely upon contingency-fee representation also tend to prefer fee-shifting. Take, for example, a franchisee whose franchise is taken away by a franchisor. If the franchisee is a corporate entity that has little value without a franchise, that party will be very glad to find a fee-shifting clause in the franchise agreement. That clause, after all, provides a contingency-fee attorney with an improved prospect of payment while only increasing the risk to the defendant. For similar reasons, a residential tenant with no assets who is trying to keep his apartment and has no prospect of a monetary recovery will find a lawyer more easily when the lease has a fee-shifting clause. The landlord has only increased her risk in that situation by having such a term in the lease.

Fee-shifting can discourage resolution in cases where the parties are evenly matched in terms of resources, where there is a real dispute (as opposed to a very weak claim) with each side having a fair chance of prevailing and where losing would be painful but not catastrophic.

Lawyers who recommend fee-shifting clauses to their clients should have a clear idea of what the client has to gain from fee-shifting. If a client is a serial litigant with a predictable pattern of cases and a high vulnerability to nuisance-value litigation, such clauses are easier to recommend. However, if a client has no particular risk of nuisance- value litigation and it is unclear what kind of disputes might arise with other parties, a fee-shifting clause might unwittingly increase that client's risk and reduce the settlement prospects of a later dispute.

If the client's goal is risk reduction, fee-shifting clauses can have the opposite of the intended effect. Understanding a client's risks and risk preferences is the key to determining if fee-shifting will work for a particular client. ❖