

Paying by the hour: the least appealing option for clients of lawyers

By Jo Seldeslachts

In this study, we analyze a client's choice of contract in auctions where Dutch law firms compete for cases. The distinguishing feature is that lawyers may submit bids with any fee arrangement they wish. We find robust evidence that bids offering hourly rates are less attractive to clients. Our findings tentatively contradict lawyers' often-made argument that hourly rates are in a client's best interest.

Hourly fees for legal services are popular in many countries, and several explanations are offered for the widespread use of this fee structure.¹ The most commonly used argument is that a service provider who works on an hourly rate basis is more motivated to invest sufficient time in a case. As Rhode puts it, “[M]ost lawyers will prefer to leave no stone unturned, provided, of course, they can charge by the stone.”² A fixed fee, on the other hand, is thought to make service providers cut corners.

An hourly fee, however, may also incentivize the service provider to work more hours than are necessary. Clients cannot properly judge the time that contributes to a positive outcome: they often do not know exactly which services they need, nor do they know how much they should be paying for them.³ Market intransparencies make matters worse: detailed price information is hard to obtain, and different law firms' offers are difficult to compare. Lawyers can exploit these informational advantages.

Furthermore, there are often institutional barriers to entry, which limits competitive pressure from potential entrants (the right to proceed in a court is mostly reserved to lawyers admitted to the bar association). This gives law firms market power, which in turn allows them to dictate fee structures and opt for hourly fees – and compared to other fee structures, hourly fees may lead only to a more expensive bill and not necessarily to better services. In that perspective, an hourly fee is more in the interest of the lawyer than in the interest of the client.

The question is whether the hourly fee structure is the standard arrangement because the client wants it or because it allows lawyers to exert market power. Up until

¹ See Kritzer, H. M. (2009): Fee Regimes and the Cost of Civil Justice. *Civil Justice Quarterly*, 28, 344–366.

² Rhode, D. L. (1985): Ethical Perspectives on Legal Practice. *Stanford Law Review*, 37, 589–635.

³ Dulleck, U. and R. Kerschbamer (2006): On Doctors, Mechanics, and Computer Specialists: The Economics of Credence Goods. *Journal of Economic Literature*, 44, 5–42.

Table 1

Types of bids

Types of bids present	# Auctions	Total # bids			Winning # bids		
		Fixed	Mixed	Hourly	Fixed	Mixed	Hourly
Fixed, Mixed & Hourly	15	22	25	26	3	9	3
Fixed & Mixed	2	2	2	-	1	1	-
Fixed & Hourly	7	9	-	12	7	-	0
Mixed & Hourly	17	-	27	48	-	14	3
Fixed	6	14	-	-	6	-	-
Mixed	2	-	4	-	-	2	-
Hourly	2	-	-	5	-	-	2
Total	51	47	58	91	17	26	8

Auctions grouped by types of bids present. # Auctions represents the number of auctions in each group. Total # bids represents the number of bids per bid type that were offered in each group. Winning # bids represents the number of bids per bid type that won in each group.

Source: XS2Justice (XS2J); own calculations.

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now, what clients want has not yet been empirically investigated. Since clients usually do not necessarily choose from among different fee structures, information about their selection behavior is hard to come by.

Calling for bids through XS2Justice

The data used here are from auctions organized by XS2Justice (XS2J), a franchise network of legal service providers that assists consumers and small/medium-sized companies in all sorts of relatively standard disputes. The auctions are a secondary activity of XS2J. As XS2J professionals are not members of the Dutch Bar Association,⁴ which comprises lawyers qualified as advocates, they normally cannot represent their clients in court. In situations where XS2J cannot take on a case, or when the client explicitly requests a lawyer, the case is put up for auction. Most of the cases on which bidding is invited concern the disputes typically found among consumers and small/medium-sized businesses: labor disputes, family law cases, consumer disputes, and contract disputes between businesses. The bidders in the XS2J auctions are small law firms across the country, and the typical law firm bidding in the auctions has one or two offices with about 15 lawyers in total.

XS2J provides a concise summary of each case and typically invites three to five different law firms to submit a bid. Lawyers are free to submit a bid with the fee structure of their choice. Bidders do not know whom they are

competing against, nor do they know how many other bidders there are. Once all bids have come in, an XS2J lawyer discusses them with the client. Apart from the fee structure and rate, the lawyer's degree of experience is disclosed, as is the location of the lawyer's office. The client then chooses from among the bids.

Lawyers prefer hourly fees

The data set contains all calls for bids that were organized by XS2J in the period between November 2004 and December 2008. A total of 374 bids were submitted in 95 calls. However, not all data can be used to analyze clients' choices: for instance, calls in which only one bid was submitted or in which the client did not accept any of the bids are not considered in this analysis. Performance-based bids are also omitted, as each of these bids is specified in a different way and therefore difficult to compare with the other fee structures. (This only applies to a small number of bids [eight], probably due to the questionable legal status of "no cure no pay" in the Netherlands.) All in all, this leaves the sample being analyzed with 196 bids in 51 cases.

More than half of all bids in these XS2J auctions offer fee structures that differ from the standard hourly rate used in everyday practice (Table 1). Nearly one quarter of the bids (47) involved a fixed fee, while 58 bids offered a fixed fee up to a specific number of hours with an hourly rate for the hours exceeding this limit. We refer to this type of bid as "mixed."

Table 1 also gives an indication of the success of the different types of bids. Despite the fact that nearly half of all bids involved an hourly fee, the client opted for such a bid in only eight of the 51 auctions. This should of course be viewed in the context of what other kinds of bids were also available to the client in question. There were 15 auctions where all three types of fee structures were available. Although more hourly rate bids were tendered (26) in these calls than were fixed fee bids (22) or mixed bids (25), clients chose a lawyer offering an hourly fee in just three of these calls. The same pattern is discernible for the other available fee structure/winning bid combinations. This hints at hourly fees being less popular than other fee structures.

The client, however, not only looks at the fee structure, but also at the price level of the bid. In an auction involving bids with different fee types, it is usually impossible to make an *ex ante* classification according to the *ex post* costs. It is possible, however, to compare bids of the same type. For instance, a client can say that an hourly fee of 200 euros is "higher" than an hourly fee of 150 euros. A mixed bid of 2,000 euros for up to 11 hours with an hourly fee of 190 euros for every hour thereafter is

⁴ https://en.wikipedia.org/wiki/Bar_association

also “higher” than a mixed bid of 1,600 euros for up to 10 hours with an hourly fee of 170 euros for every hour thereafter. In our analysis, we use the variable “higher” to distinguish such seemingly unattractive bids from other bids. This is a dummy that is equal to 1 if and only if another bid has been submitted that turns out to be cheaper for each number of hours in cases where bids can be compared.

Table 2 shows the average rates for each type of bid. The average hourly fee is 178 euros. The lowest hourly fee, 100 euros, is virtually equal to the hourly fee (99 euros) set by law for subsidized legal assistance at the time of the auctions examined in this study. The average fixed fee is 2,000 euros. The fixed component of mixed bids averaged 2,179 euros. The average hourly fee for hours exceeding the preset limit in mixed bids was 154 euros; the preset hourly limit averaged 16 hours.

Regression analyses

To support our finding that hourly fees are less attractive to clients, we performed a series of regression analyses using information that the clients had about the lawyers in addition to the fee structure. This information included the lawyers’ professional experience and the distance between the client’s home address and the lawyer’s office.

Table 3 shows the estimation results of three different specifications in which the dependent variable is a dummy indicating whether or not the bid has been selected by the client. The main explanatory variables are the dummies characterizing the fee structure: here, “fixed” or “mixed.” The “hourly” category has been omitted here, and the “fixed” and “mixed” coefficients thus must be interpreted in relation to hourly rates. The dummy “higher” in the specifications (2) and (3) indicates that there is at least one bid in the call which gives *ex ante* a higher bill than in other comparable bids.⁵ Experience and distance are measured against the highest value in the auction. The models are estimated using a conditional logit model.⁶ This estimation method automatically checks for differences in the number of bids per auction, as well as for case-specific features that are not observable. The standard errors are clustered by call.

The coefficients in the table are exponentiated so that the values can be interpreted in terms of odds ratios. The odds ratio is the relation between the probability that the bid wins and the probability that the bid does not

⁵ For details, see Felsö, F., Onderstal, S., Seldeslachts, J. (2014): What Clients Want: Choices Between Lawyers Offerings, Tinbergen Institute Discussion Papers, 2014(020).

⁶ For a detailed description, see, for example, Hosmer Jr., D. W., Lemeshow, S. (2000): Applied Logistic Regression.

Table 2

Height of bid according to bid type

In euros

	N	Fee			
		Mean	Sd	Min	Max
Hourly fee	98	178	30	100	268
Fixed fee	51	2,000	1,364	150	6,360
Mixed fee	62				
Fixed fee part		2,179	1,040	275	5,500
Hourly fee part		154	30	100	239

Source: XS2Justice (XS2J); own calculations.

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win. For example, if an hourly fee bid wins one bidding round in three calls, the odds ratio is 1/3 divided by 2/3, or one to two. Table 3’s coefficients indicate, for both fee types, by what factor the odds ratio of a fee type increases in relation to an hourly fee. A fixed fee has a coefficient of more than 3 in column (3), and thus appears to be far more attractive to the client than does an hourly fee. A mixed fee structure is in fact even more appealing, with an odds ratio of nearly eight: a mixed bid increases the odds ratio from one-to-two to eight-to-two.

The results show that the results—that clients prefer fixed fees and mixed fees to hourly fees—remain unchanged

Table 3

Winning Bids

Main results

	(1)	(2)	(3)
Fixed	4.370***	3.157**	3.499**
Mixed	7.794***	7.512***	7.762***
Higher		0.232***	0.171***
Experience			2.929*
Distance			0.419
Observations	196	196	196
Auction hit rate	0.804	0.765	0.706
Log likelihood	-50.59	-44.65	-42.26
χ^2	15.41	20.06	21.83

The dependent variable represents whether a bid has won or lost. We use the conditional logit estimator with auction fixed effects. Coefficients are reported in terms of odd ratios. Robust standard errors, clustered over the auction are reported in parentheses. * $p < 0,10$, ** $p < 0,05$, *** $p < 0,01$.

Source: XS2Justice (XS2J); own calculations.

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when we control for the height of the bid and the characteristics of the lawyer that are observable by the client: clients prefer fixed and mixed fees to hourly fees. The size of the effects also remains roughly the same.

Table 3 shows estimated coefficients of the variable “higher” in the order of 0.2. This means that a higher bid decreases the odds ratio by approximately a factor of five. Not unexpectedly, high fee rates are unattractive to clients; on the other hand, the lawyer’s professional experience is appreciated. The physical distance between the client’s home address and the lawyer’s office has no significant effect on the client’s choice.

The results of a conditional logit estimator, however, are only valid if the choice between two fee structures is independent of a third (irrelevant) alternative. In other words, the odds ratio with a fixed fee in relation to an hourly fee should not change depending on whether the client’s choice set also contains a mixed fee bid. A series of generalized Hausman tests in which one of the bid-type dummies is left out each time shows that this assumption holds true for the data. The assumption of independence of irrelevant alternatives is not dismissed and the results of the conditional logit estimation method are therefore valid.

In principle, the specification presented in column (3) of Table 3 includes all information that a client has about the lawyer. Nevertheless, it would be instructive to examine whether the lawyers’ bidding experience has any indirect effect on the probability ratio. A series of estimates with alternative specifications shows that this is not the case. Bidding experience does not appear to play a part: the number of auction participations or previously won bids, or whether a lawyer is bidding for the first time, do not appear to have a significant effect on winning.⁷

It also shows that lawyers with more experience in XS2J auctions do not change their bidding behavior. Quite the opposite: it seems that the characteristics of each individual case are primarily what induce lawyers to bid with a particular fee structure. This lack of strategic bidding behavior on the part of lawyers enables us to focus exclusively on the client’s choice.

It cannot be ruled out that the case characteristics also play a part in the client’s choice. Clients may find hourly fees more attractive in cases that are more important to them – for example, if the dispute involves emotional matters, such as family issues or disputes between

Table 4

Ex-post level of satisfaction

	Fixed	Mixed	Hourly	Total
Not satisfied	1			1
Acceptable	1	2	1	4
(Very) Satisfied	6	9	4	19

Source: Author-conducted telephone survey on client satisfaction.

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neighbors, and/or large sums of money. The extent to which this element comes into play can be inferred by including interaction terms between case characteristics and the dummies that characterize the bid. The coefficients of those interaction terms appear to be insignificant, whereas the other results remain unchanged to a large extent.⁸ This means that clients are no less averse to hourly fees even in these more financially or emotionally important cases.

Another possibility is that the kind of client determines the preferences: is the client a natural person or a company? Clients with more financial means (such as companies) probably attach greater importance to the lawyer’s efforts, and may therefore be more willing to pay an hourly fee. This, however, turns out not to be the case: business clients do not tend to opt for hourly fees either.

Fixed fees do not make for laziness

Those who defend hourly rates claim that the risk of a fixed fee is that the lawyer might not put all of their effort into getting a good result. A comparison of client satisfaction between clients who chose an hourly fee and those with who went with other fee structures is therefore instructive. All clients in the sample were contacted by phone in the spring of 2011 and asked whether they were satisfied with the lawyer they had chosen through XS2J. All clients who could still be reached using the contact details they had provided at the time of the XS2J auctions were willing to give information about their client satisfaction.

Most clients who hired a lawyer through the XS2J auctions were either (very) satisfied or found the service they received acceptable, that is, satisfactory (Table 4). Clients who paid hourly rates were not significantly more satis-

⁷ For details see Felsö, F., Onderstal, S., Seldeslachts, J. (2014): What Clients Want: Choices Between Lawyers Offerings, Tinbergen Institute Discussion Papers, 2014(020).

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fied than were clients who opted for a fixed fee or mixed fee bid. Therefore the traditional argument that hourly fees lead to a better service does not hold here.

No race to the bottom

The results of the client satisfaction survey do not give the impression that price competition leads to poor service quality. It should be noted that the usual quality guarantees such as qualification requirements and professional rules apply to the legal profession, irrespective of whether XS2J organizes the auction or the client approaches the lawyer directly. It is also quite possible that XS2J plays a complementary role in this respect by barring law firms with a poor reputation from bidding. XS2J has substantially more information about the quality of lawyers than does the average client, and has every interest in making sure no mistakes are made. After all, organizing auctions is just a secondary activity in the

services of XS2J, which has its reputation as a legal service provider to uphold.

Conclusion

The XS2J auctions in which lawyers competed directly with each other yielded many bids with fee structures that differed from the standard hourly fee structure. These auctions thus offer a unique opportunity to investigate clients' preferences, and our analysis indicates that the hourly rate is the least popular option. Our results are therefore in line with the idea that market power enables lawyers to offer hourly fees for legal services, and inconsistent with lawyers' often-stated reasoning that hourly rates are in a client's best interest.

Our findings suggest that holding auctions in which lawyers bid on cases may benefit clients, as it forces lawyers to compete with each other directly.

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