Incentive Structures for Class Action Lawyers

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Abstract
Unlike ordinary litigation where courts rarely intervene with litigants’ contractual relations with their lawyers or in settlement decisions, in class actions courts are required to do both. This paper examines the ex post optimal attorney fee structure, that would maximize the expected recovery for class members in the class action. Using a mechanism design approach we demonstrate that when the court can observe the lawyer's effort the optimal payoff may be realized using the lodestar method -- a contingent hourly fee arrangement which is currently practiced in many class actions -- but only if the hourly contingent fee is multiplied by a declining, as opposed to the practiced constant multiplier. We then show that when the court cannot observe the lawyer's effort the lawyer must be offered a choice among a schedule of fees, each consisting of a fixed percentage and a threshold amount below which the lawyer earns no fee, with the threshold increasing with the chosen percentage. The lawyer is paid the fixed percentage chosen only for amounts won above the threshold. Finally, we show that the class’ maximum expected payoff is the same regardless of whether the court can observe the lawyer’s effort or not.

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