Skin in the Game: The Promise of Contingency-Based M&A Fees

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INTRODUCTION

In February 2000, *The American Lawyer* reported that the venerable law firm of Cravath, Swaine & Moore (Cravath) entered into an agreement to help its client, Time Warner Inc. (Time Warner), merge with American Online (AOL).\(^1\) Normally, such an engagement would not be news. In 2013, for example, Cravath was legal counsel on fifty-four mergers totaling $144 billion dollars in total value.\(^2\) The details of few of these engagements were reported, despite much more widespread news coverage of the legal industry. However, the AOL agreement was different—for a reason that had nothing to do with the merger itself. The reason this contract drew so much attention and scrutiny was the nature of the fee that Cravath and Time Warner had negotiated. The contract called for a $35 million fee to be paid to Cravath if, and only if, the merger with AOL closed successfully.\(^3\) A small flat fee would be paid if the merger was unsuccessful.\(^4\) This agreement required Cravath to put some of its proverbial “skin in the game.”\(^5\) As reported at the time, this fee arrangement was highly unusual and was considered a new frontier in mergers and acquisitions (M&A) legal fees.\(^6\)

At the time of the Cravath–Time Warner contract, it was reported that the push for a contingent fee arrangement came from Chris Bogart, Time Warner’s general counsel.\(^7\) This fact—along with other, sporadic accounts of contingent


\(^3\) Crawford & Hall, supra note 1.


\(^5\) William Safire, *Skin in the Game*, N.Y. TIMES, Sept. 17, 2006, http://www.nytimes.com/2006/09/17/magazine/17wwln_safire.html (“The skin in this case is a synecdoche for the self, much as ‘head’ stands for cattle and ‘sail’ for ships. The game is the investment, commitment or gamble being undertaken. Thus, investors in a company will be more comfortable in their own skins if they know that the managers are personally invested as well—that they share the risk and have an incentive to share the gains.”).

\(^6\) See Crawford & Hall, supra note 1 (“Outside observers say that it’s the first time they’ve heard of a firm taking corporate work on a contingency basis.”).

\(^7\) See id.
fees for M&A deals—demonstrates that at least some clients are interested in alternative contractual arrangements with their M&A lawyers. This Note seeks, for the first time, to explain a general theory of contractual choice in M&A legal fee agreements and to identify the specific circumstances in which parties might agree to a contingent fee arrangement.

Part I examines fee structures for the two different types of professional services necessary for an M&A transaction: investment bankers and transactional lawyers. Part II asks why, given common external constraints, we observe disparate contractual arrangements in the real world between these groups and their clients. Borrowing from Professor Stephen N. S. Cheung’s classic explanation, Part II explains that transaction costs and differences in risk preference lead to different contractual arrangements. Further, it predicts when we would expect to see the three prototypical types of contracts: wage, lease, and share. Part III builds on this classification and identifies the factual circumstances that would push lawyers and their clients to agree on a fee contingent on the consummation of a transaction. It focuses on three categories of risk more controllable by lawyers than their clients: tax risk, antitrust risk, and hostile acquisition risk. Finally, Part IV proposes four different variations on the basic share contract in an M&A setting and identifies the advantages and disadvantages of each variation for both lawyers and clients.

I. TYPES OF M&A PROFESSIONAL SERVICES FEES

This Part identifies the two types of professional service providers who play primary roles in an M&A transaction and examines the ways their compensation is typically structured. This comparison is crucial because although investment bankers and transactional lawyers are the two key service providers for an M&A deal—and oftentimes have duties that significantly overlap—they are compensated quite differently. In order to later understand alternative compensation methods for transactional lawyers, it is important to understand how the other major player is compensated. This comparison will be revisited when the Note proposes alternative compensation structures for transactional lawyers.


A. INVESTMENT BANKERS

Investment bankers typically charge a variable fee that is payable contingent on the deal closing when they are engaged to work on an M&A transaction.¹⁰ The standard variable contingent fee (success fee) is a percentage of total deal consideration. This fee is paid only when the transaction closes.¹¹ In addition, some investment banks charge secondary fees, such as a retainer fee or minimum transaction fee.¹² These fees are often paid only if the transaction does not close, and are often credited against the success fee if the transaction does not close.¹³

1. Variable Contingent Fees

Investment bankers who are engaged for M&A transactions are typically paid on a commission basis,¹⁴ similar to real estate agents.¹⁵ They contract to receive a variable percentage of the total transaction consideration upon closing.¹⁶ The original conception of this compensation system was called the Lehman Formula.¹⁷ This formula was developed by the Lehman Brothers investment bank in the 1970s to calculate fees for underwriting and other capital-raising transactions.¹⁸ However, it has since become the industry standard for investment banks to charge in connection with M&A transactions.¹⁹ These formulas apply to the total consideration paid from a buyer to a seller.²⁰ The original Lehman Formula dictates the following payments:²¹

11. See id.
15. See Mary Szto, Dual Real Estate Agents and the Double Duty of Loyalty, 41 REAL EST. L.J. 22, 30–31 (2012) (“[A]pproximately 94% of agents are paid on commission . . . . based on a percentage of the sales price of the home . . . . The contingency fee is normally paid from the sale proceeds from the borrower’s bank to the seller. The commission is based on the sales price of the home and can typically range from 5-7%.” (footnotes omitted)).
16. See id.
20. See id.
21. See MAL T, supra note 17.
Many investment banks today use some variant of the Lehman Formula to increase their compensation.22 Some banks choose to use the Double Lehman Formula.23 This structure doubles the percentages for each applicable bracket.24 Such an adjustment is highly favorable for bankers. This is but one of many variations on the basic Lehman Formula that makes up the contingent portion of investment bankers’ compensation. Each conditions a significant part of the bankers’ payment on the size and ultimate success of the transaction.

2. Secondary Fees

In addition to the success fee, investment banks typically negotiate two other secondary fees with their clients in connection with M&A activity: a retainer fee and a minimum transaction fee.25 Investment banks often contract for a retainer fee to be paid by clients from the outset of engagements.26 This is usually a small monthly payment explained by two rationales: to compensate the bank for the overhead costs of working on the transaction and to align the client’s incentives with those of the bank.27 One investment banking firm explains:

Retainers keep the lights on, and they further assure us that the seller has as much on the table as we do. We find that low or absent retainers seem to convey the unfortunate impression that our services may not be worth much. . . . In sum, the retainer fee is insurance that our time will be at least partially compensated, and it keeps the client moving in a timely fashion toward a successful conclusion.28

Because the fee is intended to compensate the bank for expenses in case the deal does not close and to encourage the client to complete the transaction, retainer fees are typically credited against the ultimate success fee paid to the

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27. See id.
28. Id.
bank if the deal closes.\textsuperscript{29}

Investment banks typically also agree on a minimum transaction fee before accepting an engagement.\textsuperscript{30} This covers the unlikely situation where a transaction makes sense economically for the client, but is for a much smaller total value than expected ex ante by the bank and the client.\textsuperscript{31} In this case, a minimum preset fee would be paid to the bank, regardless of the total transaction size.\textsuperscript{32}

B. TRANSACTIONAL LAWYERS

Transactional lawyers, on the other hand, are typically paid in one of three ways: hourly fees, flat fees, or adjustable fees.\textsuperscript{33} These fees are typically paid regardless of whether the transaction is successfully completed.\textsuperscript{34} In addition, listing these three methods together may be somewhat deceptive; hourly fees are by and large the dominant method of billing clients for transactions today.\textsuperscript{35}

The traditional model for billing legal transactional work is the hourly fee.\textsuperscript{36} Each lawyer on a transaction has an hourly rate that she charges.\textsuperscript{37} Typically, this hourly rate varies by seniority, specialty, and geographic location.\textsuperscript{38} Hourly rates for partners can range from $360 to $1,800.\textsuperscript{39} On a given deal, a lawyer works for the number of hours necessary to accomplish the legal tasks associated with a transaction. Afterwards, the client is billed for the number of hours worked by that lawyer multiplied by that lawyer’s hourly rate.\textsuperscript{40} This is the traditional model in the world of corporate transactions.\textsuperscript{41}

\textsuperscript{29} See Investment Bank Fees, supra note 10.
\textsuperscript{30} See id.
\textsuperscript{31} See id.
\textsuperscript{32} See id.
\textsuperscript{36} See, e.g., id.
\textsuperscript{38} See, e.g., Karen Sloan, NLJ Billing Survey: $1,000 Per Hour Isn’t Rare Anymore, Nat’l L.J., Jan. 13, 2014, at 1.
\textsuperscript{41} See, e.g., id.
A less-traditional model is for a lawyer to charge her client a flat fee for a given piece of legal work. This rate is usually set in advance by negotiation. A lawyer and her longtime client might discuss the components of the transaction, the expected time to complete each component, and the actual expenses anticipated to be incurred in the course of the transaction. On the other hand, a first-time client might shop around and solicit quotes from a number of lawyers to determine the most cost-effective provider. Flat fees are typically utilized in more rote, piecework engagements such as business incorporations or real estate closings. Flat fees are less typical in complex, bespoke corporate transactions such as mergers and acquisitions. There is no reason, however, that flat fees could not be utilized more often in M&A and other transactional contexts, especially between experienced clients and their lawyers.

Finally, adjustable fees are utilized on a less-formal basis between lawyers and clients with longstanding relationships. This structure provides for an hourly or flat fee arrangement for a transaction, with the understanding between the parties that the total fee will be adjusted based on the success of the transaction. For instance, often “[t]here may be an opportunity for a closing bonus fee, although, if a deal does not occur, there may be a request for a discount.” Sometimes this discount takes the form of writing off a first-year associate’s hours or reducing the overall bill by a set amount. These three basic models—hourly fees, flat fees, and adjustable fees—illustrate the contractual agreements that most transactional lawyers reach with their clients.

II. VARIATION IN CONTRACTUAL CHOICE

Though it is understandable that different types of professional service providers may be compensated differently, it is not intuitive why clients and
their lawyers would arrive at any specific contractual arrangements in the M&A context. Writing in 1969, Professor Stephen N. S. Cheung provided a then-groundbreaking and innovative explanation of this variation in contractual form, attributing the ultimate choice of contractual arrangement between two parties to transaction costs and differences in risk preferences. This Part discusses Cheung’s theory at length, for it lays the analytical structure for much of the rest of this Note.

Cheung’s contribution in this regard cannot be overstated. Others have written that “[i]n a seminal work, Steven N. S. Cheung observed that the risk of crop failures may be (1) borne entirely by tenants . . . ; (2) split between landlord and tenant . . . ; or (3) borne entirely by the landlord,” that Cheung has “expanded the breadth of economic analysis to core private law topics such as . . . contracts,” and that “[i]n a seminal contribution to the economic analysis of law . . . Steven Cheung describes sharecropping as a risk-sharing device.” In this analysis, Cheung identifies three contractual types that embody different compromises between transaction costs and risk preferences: wage contracts, lease contracts, and share contracts. Cheung sets out his theory of contractual choice in the context of Asian agriculture. The contractual types that he identifies and the factors that dictate the choices among them, however, are equally applicable to contracts for legal work in the M&A context.

Cheung begins by identifying the crucial question: Why is there “a variety of contractual arrangements under the same constraint[s]”? His answer is two-fold. First, “[u]nder the postulate of risk aversion, an individual will seek to avoid risk if the cost of doing so is less than the gain from the risk averted.” Second, different contractual arrangements exist because there are different transaction costs associated with them. He concludes that “the choice of contractual arrangement is made so as to maximize the gain from risk dispersion subject to the constraint of transaction costs.” He proceeds to describe the three basic types of contracts from which parties may choose.

50. See Cheung, supra note 9, at 23–24.
53. Daniel B. Kelly, The Right to Include, 63 Emory L.J. 857, 876 (2014). Furthermore, “Steven Cheung has shown that various property arrangements may be efficient and that individuals therefore choose different contract arrangements under varying conditions . . . . Cheung focuses on transaction costs and risk to develop a theory that explains the divergence of property arrangements.” Hanoch Dagan & Michael A. Heller, The Liberal Commons, 110 Yale L.J. 549, 562 n.47 (2001) (citation omitted).
54. Cheung, supra note 9, at 25.
55. See id.
56. Id. at 23.
57. Id. at 24.
58. See id.
59. Id. at 25.
A. RISK PREFERENCES

The first factor that dictates the choice of contractual arrangement is risk preference. Basic theories of risk aversion and insurance dictate that when two parties have different risk tolerances and declining marginal utility of income, risk in an economic arrangement will be allocated to the less risk-averse party in exchange for a payment from the more risk-averse party. Cheung puts this into practice by studying the agreements that farmers and landowners enter into when they combine their assets and labor to produce an agricultural crop. He states first that “variables exogenous to the production function, such as weather conditions and pests, are risk factors which are difficult to forecast and which may significantly affect the variance of the value of output.” He reasons that when a landowner is risk-neutral and a farmer is risk-averse, the contract terms they agree to will allocate this risk of variable production outcomes to the landowner. However, when a landowner is risk-averse and a farmer is risk-neutral, the opposite will be true, and the farmer will take on the risk. These differences in risk preference will in part dictate the economic arrangement the parties agree to in order to engage in a productive economic activity—combining labor with land to farm a crop.

B. CONTROLLABLE RISK

The second factor that dictates the choice of contractual arrangements is transaction costs caused by controllable risk and monitoring. In contrast to the exogenous risks above, there are some endogenous risks—such as level of effort exerted by a farmer—that also influence the level of production. These risks are controllable by the farmer. This poses a moral hazard problem for the landowner; the farmer may not be properly incentivized to contribute the optimal level of effort. Unfortunately for the landowner, there are costs associated with remedying this situation by monitoring the level of effort being exerted by the farmer. The higher the level of risk controllable by the farmer, the larger the costs imposed on the landowner to monitor the farmer. Cheung suggests that the solution to this moral hazard problem is a contract that aligns the farmer’s incentives with the landowner’s, and that this variance in the level

60. See id. at 24.
61. See id. at 26.
62. Id.
63. See id. at 29.
64. See Joshua C. Teitelbaum, Professor of Law, Georgetown Univ. Law Ctr., Risk and Uncertainty: Commercial Contracts, Lecture Before the Deals: The Economics of Structuring Transactions Class 4 (Mar. 25, 2014) (on file with author).
65. See Cheung, supra note 9, at 24.
66. See id. at 26.
67. See id.
68. See Teitelbaum, supra note 64, at 5.
69. See Cheung, supra note 9, at 26.
70. See id. at 27.
of controllable risk results in the many types of contracts observed in practice. For example, when the crop is one for which the farmer’s level of effort matters quite a bit, the contract between the two parties will allocate this risk to the farmer. However, when the crop is hardy and will produce a consistent yield regardless of the farmer’s effort level, the contractual provisions will appear quite different and result in less variance in the farmer’s compensation based on output.

C. TYPES OF CONTRACTS

From these two factors—ability to bear exogenous risk and level of controllable risk—Cheung derives a general theory of contractual arrangements. He posits two prototypical contracts that result from pairing these factors: wage contracts and lease contracts. He then explains why parties might arrive on a second-best solution—a share contract—when neither prototypical contract is a perfect fit.

1. Wage Contracts

A wage contract is an arrangement where a landowner pays a farmer a set amount to work her land. The farmer’s compensation is fixed while the landowner’s is variable—the farmer has no skin in the game. Based on Cheung’s analysis, we are likely to see a wage contract when it is better for the landowner to bear risk. This type of contract, therefore, is efficient when the farmer is risk averse and the landowner is risk neutral. In addition, we are likely to see a wage contract when there are no controllable risks and therefore low monitoring costs. When the party contributing labor is more risk averse than the party with the capital asset, and transaction costs are low, the parties will likely utilize a wage contract.

In the M&A legal fee context, a wage contract represents the standard arrangement most clients and lawyers utilize: hourly billing. The lawyer contributes her labor in exchange for a fixed payment based on hours billed, regardless of the eventual success of the transaction. The client, on the other hand, incurs the costs and reaps the benefits of the transaction. Because the lawyer’s fees must be paid regardless of whether the transaction is successful, her compensation is fixed, while the upside synergy or efficiency gains from the transaction accrue exclusively to the client.

71. See id.
72. See id. at 28–29.
73. See id.
74. See Teitelbaum, supra note 64, at 3.
75. See id. at 4.
76. See id.
77. See id. at 6.
78. See id.
Because a wage contract is the most frequently observed contractual arrangement between clients and their M&A lawyers, we might assume that in most M&A transactions the lawyer is risk averse while the client is risk neutral. In addition, such a contractual solution indicates that there is typically little or no risk controllable by the lawyer, and no attendant monitoring costs that might push the parties to a different arrangement. These assumptions fit the standard portrayal in popular culture of a risk-averse lawyer who has a trusting relationship with her client.\footnote{89. See Jordan Furlong, Why Lawyers Don’t Innovate, LAW21 (Aug. 20, 2013), http://www.law21.ca/2013/08/why-lawyers-dont-innovate.}

2. Lease Contracts

A lease contract, on the other hand, is an arrangement where a farmer pays a landowner a set amount to farm her plot of land.\footnote{80. See Teitelbaum, supra note 64, at 3.} Parties are likely to agree to a lease contract when it is better for the farmer to bear exogenous risk, and there are high levels of endogenous risk.\footnote{81. See id. at 6.} Therefore, we would expect to see lease contracts in circumstances where the landowner is more risk averse than the farmer, and when factors such as crop varieties or pests might have a large impact on crop yields.\footnote{82. See Cheung, supra note 9, at 26.} Utilizing a lease contract shifts the responsibility for these controllable risks to the farmer. When the party contributing labor is less risk averse than the party with the capital asset, and transaction costs stemming from moral hazard may be significant, the parties will arrive at a lease contract.\footnote{83. See Teitelbaum, supra note 64, at 6.}

In the M&A legal fee context, it is hard to conceptualize what a lease contract would look like. However, if we did so, it seems that in an M&A lease contract, the lawyer would pay the client a fixed amount in order to proceed with an M&A transaction and would be able to capture all of the surplus generated from the transaction. This is a challenging concept; unlike in agriculture, where the profits from farming a given piece of land are certain and are realized seasonally or annually, the profits from an M&A transaction are realized over a much longer time horizon and are far less certain.\footnote{84. See Thomas J. Herd & Ryan McManus, Who Says M&A Doesn’t Create Value?, OUTLOOK (Mar. 2012), http://www.accenture.com/us-en/outlook/Pages/outlook-journal-2012-mergers-acquisitions-create-value.aspx.} However, a buy-side M&A lawyer could conceivably draft an agreement whereby the target company is isolated in a single business unit of the client acquirer, and increased profitability over a baseline year is routed entirely to the lawyer. This, however, is not an arrangement that is seen in practice, and it does not seem likely to materialize anytime soon.
3. Share Contracts

As described above, a wage contract is desirable in a situation where it is efficient to allocate risk to the landowner and there is not a strong need to incentivize the farmer to work hard. On the other hand, a lease contract is desirable when it is efficient to allocate risk to the farmer and there is a strong need to incentivize the farmer to exert optimal effort to combat moral hazard. Frequently, however, “there is a tension between what is efficient in terms of allocating risk and what is efficient in terms of providing incentives... [This] classic tension exists when the farmer is risk averse and there is high controlable risk and high monitoring costs.” In such a case, the typical solution is a hybrid: a share contract. A share contract is one in which the landowner and farmer share the risk of variable output.

A share contract is efficient when both parties are risk averse; the specific shares reflect the relative degrees of risk aversion. As Cheung notes, “the precise and at times complex delineation of resource rights between the contracting parties suggests that the [percentage] can be adjusted...so as to use resources efficiently.” A share contract can be calibrated to fit the precise endogenous and exogenous risks.

This level of flexibility is precisely what makes a share contract an intriguing model for a new type of legal fee contract: a contingency-based M&A fee. A share contract in this context might resemble the traditional investment banking contract: the lawyer would contribute her labor in exchange for some variable future payment contingent on the success of the transaction, with little or no payment in the event of failure. The lawyer and her client together incur the costs and reap the benefits of the transaction. The lawyer’s compensation is variable, and she would share in any efficiency or synergy gains that the client reaps.

A share contract is typically efficient when both parties are risk averse and controllable risk is high. This aptly describes a certain subset of M&A transactions involving large corporate clients, large law firms, and significant external—but controllable—legal risk. The specific factual circumstances under which we might expect to see lawyers and their clients agree on a share contract are detailed below.

85. See supra section II.C.1.
86. See supra section II.C.2.
87. Teitelbaum, supra note 64, at 5–6.
88. See id. at 6.
89. See id. at 4.
90. See id.
91. Cheung, supra note 9, at 35.
III. VARIATION IN M&A CONTRACTUAL CHOICE

Part II discussed how the choice of contractual arrangement is typically dictated by transaction costs flowing from controllable risk and the allocation of uncontrollable risk. Utilizing the insights from Cheung, this Part posits that lawyers and clients conducting M&A transactions should prefer share contracts when both parties are risk averse and when there is a high level of lawyer-controllable risk stemming from substantive tax, antitrust, and corporate law concerns.

A. RISK PREFERENCES IN M&A

Cheung identifies risk aversion as a powerful force in determining parties’ choice of contract.92 A party’s risk preferences in a vacuum will not dictate much, but her risk preference relative to her counterparty may have a significant impact on her choice of contract.93 Corporations seeking M&A transactions and their lawyers may have different risk preferences. These preferences in part affect their choice of fee structure for this transaction.

The crucial question is who among M&A lawyers and their clients is likely to be risk averse and who is likely to be risk neutral. A client is likely to be risk averse when it is not a repeat player and cannot pool outcomes over a longer time horizon. For instance, if the client is a smaller company that is hoping to be acquired, it may be risk averse and prefer to accept a certain, less valuable acquisition offer over holding out for more money. Additionally, if a buy-side client is hoping to acquire another company that has technology vital to its success—for instance, if the client is a pharmaceutical company with a lucrative drug coming off-patent—it may be risk averse. This is not, however, always the case. For instance, a client may be risk neutral if this M&A transaction is one of many that it engages in each year. Thus, the risk of this specific deal not closing is mitigated by the other acquisitions the client will make. In addition, a client might be risk neutral if it is a large company and is acquiring a much smaller company.

The lawyer (or law firm), on the other hand, may also be risk averse or risk neutral. In the United States, law firms are often risk averse because they do not have access to the capital markets necessary to provide an infusion of liquidity,94 and so one large failed deal with many hours of associate and partner time

92. See supra section II.A.
93. See Cheung, supra note 9, at 27. Risk aversion “refers to the tendency to prefer to pay a defined sum of money that is known with certainty instead of being exposed to the risk of suffering a larger and uncertain financial loss in the future.” David A. Cather, A Gentle Introduction to Risk Aversion and Utility Theory, 13 RISK MGMT. & INS. REV. 127, 128 (2010). Risk neutrality, on the other hand, assumes indifference between levels of risk, so long as expected outcomes are equivalent. See Amanda Cohen Leiter, Note, Environmental Insurance: Does It Defy the Rules?, 25 HARR. ENVTL. L. REV. 259, 263 n.16 (2001).
invested might determine survival. In addition, a law firm might be risk averse if it has significant overhead expenses or has large ongoing compensation commitments to partners that lateraled from other firms. In the alternative, there are circumstances in which a large law firm might be risk neutral. Large law firms advise on many M&A transactions each year and may be able to pool the risk associated with any individual transaction. Most large law firms also have internal capital allocations committed to funding contingent-fee litigation—one could imagine such a committed allocation for contingent fee M&A transactions. The existence of such a dedicated pool might mitigate the risk aversion of some of the partners. On the whole, it seems most likely that lawyers are risk averse in most circumstances. Risk preferences, however, do not tell the entire story of the choice of contract between clients and lawyers.

B. CONTROLLABLE RISK IN M&A

Cheung’s analysis of the endogenous risks in an arrangement between a landowner and a farmer has direct parallels to the arrangement between a corporation and its lawyers to engage in a merger or acquisition. Recall that Cheung identifies the transaction costs associated with monitoring the farmer’s behavior as one of the major drivers of the choice of contract. To generalize, as an agent’s behavior grows more important in determining the ultimate success or failure of an endeavor, a principal must invest more time and money in monitoring this risk. In situations when this level of risk is anticipated to be high, and both parties are risk averse, the principal and agent will agree on a contract that allocates some of this risk to the agent: the share contract.

In the M&A context, lawyers and their clients should agree to share contracts when there is a high level of risk, controllable primarily by the lawyer, and both lawyer and client are risk averse. This type of contract incentivizes the lawyer to pursue a profitable merger with appropriate vigor while simultaneously reducing monitoring costs. In today’s M&A world, these high levels of controllable risk may stem from three likely sources: structuring transactions and obtaining advance rulings to ensure tax-free treatment; strategically advocating to ensure antitrust regulatory approval; and effectively navigating the world of hostile acquisitions.

98. See Furlong, supra note 79.
99. See supra section II.B.
100. See Teitelbaum, supra note 64, at 6.
1. Tax Risk

M&A lawyers and their clients often seek to avoid incurring tax liability in conjunction with M&A transactions.\textsuperscript{101} However, transactions sometimes fail to gain tax-free treatment because they either do not meet the statutory requirements or fail to gain preapproval from the IRS for new, purportedly tax-free structures. This is a significant risk—one that can scuttle a transaction altogether—that is largely controlled by the tax lawyers working on the deal. Typically, when a company is sold, one or both of the parties must recognize income and pay income taxes as a result of that sale.\textsuperscript{102} However, the Internal Revenue Code prescribes rules that “grant preferential tax treatment to a significant volume of [M&A] transactions”—transactions described as “reorganizations.”\textsuperscript{103} Therefore, “[i]n certain circumstances, the reorganization rules allow some taxpayers not to recognize (and therefore not to be currently taxed on) the gain they realize in these transactions.”\textsuperscript{104}

If a transaction is not tax-free, parties typically incur significant tax liability.\textsuperscript{105} This risk of increased taxes associated with a transaction may determine whether the transaction happens at all. Therefore, the “[t]ax benefits are significant . . . in the decision of how to execute an M&A transaction and particularly in the choice of payment methods.”\textsuperscript{106} For example, consider an acquisition where the acquiring corporation offers $500,000 in cash to shareholders of the target corporation in exchange for 100 percent of their stock in the target corporation, which has a basis of $150,000. Because this does not qualify as a tax-free reorganization, the target shareholders have $350,000 in taxable gain. Had the lawyers for the target shareholders insisted that the acquiring corporation pay for the target corporation’s stock with voting shares in the acquiring corporation, this would qualify as a stock-for-stock tax-free reorganization under Internal Revenue Code § 368(a)(1)(B), and the target shareholders would have no current taxable gain. In this case, the structure of the transaction means the difference between $350,000 and $0 in taxable gain. The risk that a transaction is not tax-free is thus a significant impediment to the likelihood of the transaction occurring.

Lawyers have the unique ability to control this tax risk by structuring transactions within the confines of the tax-free reorganization provisions. As described above, the rules that govern whether an M&A transaction is tax-free are complex and set out in detail in the Internal Revenue Code. As a result,
ensuring that the transaction conforms to those rules is the domain of the tax lawyer.\textsuperscript{107} An experienced practitioner describes the crucial importance of the tax lawyer in controlling tax risk, noting that “it is vital . . . to consult a tax lawyer at every stage of an acquisition transaction . . . Details that are minor from a corporate point of view . . . can have vast consequences from a tax point of view.”\textsuperscript{108}

In addition to the basic structuring work that tax lawyers do in connection with M&A transactions, they also control tax risk by receiving advance approval for tax-free treatment of innovative transactional structures through Private Letter Rulings (PLRs) from the IRS. PLRs are “written statement[s] by the [IRS] National Office, prepared in response to a written request from a taxpayer that states how it will treat a prospective or completed transaction for federal tax purposes.”\textsuperscript{109} PLRs are not a part of every M&A transaction. Rather, these written requests are typically submitted to the IRS by a taxpayer after preparation by its tax lawyer when it desires greater certainty as to the treatment of a transaction.\textsuperscript{110} A PLR informs a taxpayer whether the IRS will consider its proposed transaction as resulting in taxable gain. The presence or absence of a positive PLR represents lawyer-controllable risk because a grant of a PLR is heavily influenced by the skill with which a lawyer prepares the “detailed recital of the relevant facts of the transaction”\textsuperscript{111} in her client’s submission to the IRS. If the lawyer does not obtain a favorable PLR, a proposed transaction may be terminated, and the client may not realize the economic benefits motivating the transaction.

2. Antitrust Risk

A second significant risk to a proposed M&A deal that is often controllable by lawyers is the risk of antitrust restriction or blockage. All U.S. mergers must obtain Hart–Scott–Rodino antitrust preclearance from the Federal Trade Commission (FTC) or Department of Justice (DOJ).\textsuperscript{112} The restrictions that these agencies can impose, and their ability to block transactions altogether, represent a threat to a client realizing the benefits of its M&A transaction. When lawyers plan and litigate effectively, they may be able to reduce or eliminate the risk that antitrust regulators will interfere with the proposed transaction.


The Clayton Antitrust Act of 1914 prohibits mergers and acquisitions where the effect of the transaction “may be substantially to lessen competition, or to tend to create a monopoly.”113 This legislation grants the FTC and DOJ shared enforcement power.114 To facilitate enforcement of the Clayton Act, Congress passed the Hart–Scott–Rodino Antitrust Improvements Act of 1976, which requires that most “acquisitions of assets or voting securities in excess of $15 million be reported to both the DOJ and the FTC . . . . Following notification, the parties must observe a statutory waiting period, designed to give the agencies time to review the transaction.”115 A reviewing agency then has the ability to, within thirty days, make a Request for Additional Information (Second Request).116 If there is a Second Request, the parties must wait an additional twenty days after complying with the request to complete the transaction.117

When there is a Second Request, the transaction may be at serious risk.118 If the reviewing agency determines that the merger or acquisition is likely to substantially lessen competition, it may seek to preliminarily enjoin the transaction in federal court.119 In addition, it may seek other remedies through a negotiated settlement such as divestiture of assets120 or limitations on the acquiring corporation’s conduct.121 It is clear why a long-term injunction of a merger or acquisition is risky for the parties to the transaction: it results either in the transaction being permanently blocked or in the “risk that the value of the merging company would diminish through losses of customers and key employees because of continued uncertainty surrounding the outcome.”122 Indeed, some lawyers have commented that “[o]ften, the threat of an injunction was enough to cause the parties to abandon the transaction. If the enforcement agency obtained an injunction, most deals simply disintegrated. Neither the companies nor their sources of financing were willing to tolerate litigating a case through a trial.”123

115. Id. at 891.
116. See id.
117. See id. at 891–92.
119. See Kolasky, Jr. & Lowe, supra note 114, at 892.
121. See id. at 12–20.
In addition, the alternative remedies of asset divestiture or conduct limitations may pose a risk to the corporation as well. If a company is forced to sell off assets\(^\text{124}\) or an operating unit,\(^\text{125}\) or is limited in its communications with subsidiaries\(^\text{126}\) or ability to negotiate with licensees,\(^\text{127}\) there may be destruction of some or all of the synergistic value that the merger was originally intended to generate. Though these remedies are taken to benefit the public interest, the private interests of the merging corporation and its shareholders are clearly at risk from the moment the premerger review period begins.

Lawyers can often, though not always, control and limit antitrust regulatory risk by planning effectively when negotiating the merger and by litigating zealously once a merger has been enjoined in federal court. First, deal lawyers negotiating a transaction may be able to mitigate future antitrust risk through a number of contractual mechanisms: an efforts covenant,\(^\text{128}\) a divestiture covenant,\(^\text{129}\) and a closing condition,\(^\text{130}\) to name three. Lawyers typically negotiate these covenants, which(dictate the various rights and responsibilities of the parties to the transaction in connection with antitrust review, with input from their clients.\(^\text{131}\) Most parties understand that effective planning and negotiation result in “approaches that parties can use to understand, evaluate and parse antitrust risks in a manner that may allow” a deal to proceed.\(^\text{132}\)

Second, litigators who are confronted with substantive antitrust challenges from the FTC or DOJ may also be able to take efforts to control risk to the transaction. Even if a merger is challenged in federal court, it is by no means doomed to failure.\(^\text{133}\) Effective lawyering can result in outright victory\(^\text{134}\) or a settlement that represents a better outcome than the parties otherwise expected. When antitrust litigators are able to sustain a deal despite regulatory scrutiny, or

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\(^{124}\) See Antitrust Division, supra note 120, at 7–8.

\(^{125}\) See id. at 8–11.

\(^{126}\) See id. at 13–14.

\(^{127}\) See id. at 15–16.


\(^{129}\) See id. (“The level of divestitures the buyer is contractually required to accept in order to obtain the required approvals, which can range from silence to the proverbial ‘hell or high water.’”).

\(^{130}\) See id. (“What level of challenge from an antitrust authority is required before the buyer can assert that it is not required to close.”).

\(^{131}\) See Stephen I. Glover et al., Allocating Antitrust Risk in Merger Agreements, Insights, Oct. 2013, at 10, 11 (“If possible, the antitrust lawyers and business teams should start their work early, when they first begin considering the proposed deal.”).

\(^{132}\) Frank Aquila & Melissa Sawyer, Speed Reading: Top 10 Ways to Address Antitrust Risk in M&A Transactions, Emerging Issues, Sept. 2012, at 1, 1.


\(^{134}\) See, e.g., FTC v. Lundbeck, Inc., Civil Nos. 08-63709 (JNE/JJG), 08-6381 (JNE/JJG), 2010 WL 3810015 (D. Minn. Aug. 31, 2010).
maintain the major synergies the parties hoped to achieve despite negotiated remedies, they control risk that might prevent a successful M&A transaction.

3. Hostile Acquisition Risk

Hostile acquisitions represent a third area where lawyers can control risk that threatens the success of a transaction. Strategic maneuvering by an acquiring or target corporation can result in an unwelcome or less economically advantageous transaction for the other party. Transactional lawyers can control these risks by utilizing creative measures.

When entering into a merger or acquisition, the parties have diametrically opposed objectives: the acquiring corporation wants to purchase control of the target corporation for as little consideration as possible, and the target corporation seeks to extract the maximum possible purchase price from the acquiring corporation. Each party faces a general risk of being unable to fully achieve its goal. This general risk is present regardless of whether it is a friendly or hostile transaction. When an acquirer, for instance, pays less for the target than it expected, it is able to realize a larger surplus from the transaction. Each party negotiates in order to come as close as possible to achieving its general economic objectives.

There are, however, specific risks to a profitable deal when a target company in an M&A transaction is an unwilling participant—risks to both the hostile acquirer and the reluctant target. The risk to the acquiring company is that the target board will resist its overtures and refuse to participate in a value-creating transaction. On the other hand, the risk to the target company is that the acquiring company will appeal to the short-term interests of the target’s shareholders and seek to purchase the company at what is perceived by the board to be a discount. In contrast to a negotiated transaction, each party to a hostile M&A transaction is at risk of entering into a transaction that is less economically advantageous than it had initially hoped.

To a large extent, transactional lawyers are able to control and mitigate the risk of a poor economic outcome in a hostile takeover through the use of innovative tactics. Because federal securities law and state corporation law typically restrict these tactics, lawyers are often the primary players in formulating strategies to control economic risk to their clients. The more creative and novel the strategies that the lawyers devise, the more value they are

137. See Michael Aiello, Creative and Proactive Lawyers, FIN. TIMES (NOV. 21, 2013, 4:00 AM), http://www.ft.com/intl/cms/s/0/7612f8f2-4bb5-11e3-8203-00144feabdc0.html.
able to generate for their clients in a given transaction. To see this dynamic in play, consider perhaps the most famous lawyer-created defensive tactic: the shareholder rights plan.

In the 1970s, hostile bidders were taking over companies with increasing frequency, and there was little in lawyers’ existing arsenal to help target companies resist.\footnote{See Shira Ovide, Marty Lipton: Why I Invented the Poison Pill, WALL ST. J. (Dec. 29, 2010, 1:33 PM ET), http://blogs.wsj.com/deals/2010/12/29/marty-lipton-why-i-invented-the-poison-pill.} Marty Lipton, an M&A lawyer in New York, says it was then that he “dreamed up the shareholder rights plan . . . in 1982 to give boards of a target company a chance to ‘level the playing field’ and have time to weigh offers.”\footnote{Id.} A shareholder rights plan operates in the following manner:

Generally, a [shareholder rights plan] issues rights to all existing shareholders, with the exception of the hostile suitor, to acquire stock of the target (or of the aggressor upon a subsequent merger) at prices significantly below market. These rights are triggered by certain specified events, such as the announce-ment of a cash tender offer or the acquisition by an outsider of a specified percentage of the target’s shares. Thus, a [shareholder rights plan] is effective because it dilutes the economic interest of the hostile suitor in the target, making the transaction both economically unattractive and impractical if pursued on a hostile basis.\footnote{Poison Pill, MACABACUS, http://www.macabacus.com/defense/poison-pill (last visited Apr. 26, 2014).}

Shareholder rights plans—originally conceived of by a lawyer for his clients who were targeted in hostile acquisitions—remain in their technical and strategic details the domain of the deal lawyer. To quote one prominent deal lawyer, “[T]o really understand the uniqueness of hostile deals, you need to understand the nature of board duties by which the board will be judged when they try to use a [shareholder rights plan] to stop a tender offer dead in its tracks.”\footnote{Ronald Barusch, WSJ M&A 101: The Origins of the Takeover Wars, WALL ST. J. (Dec. 10, 2010, 2:03 PM ET), http://blogs.wsj.com/deals/2010/12/10(wsj-ma-101-the-origins-of-the-takeover-wars.} The nature of a shareholder rights plan is an inherently legal question that ends up being resolved by lawyers. Because shareholder rights plans are rarely trig-gered,\footnote{See Charles M. Nathan, Triggering a Poison Pill, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Apr. 11, 2009, 11:28 AM), https://blogs.law.harvard.edu/corpgov/2009/04/11/triggering-a-poison-pill.} they primarily serve as a deterrent mechanism to allow the target board to realize greater value for its shareholders before the plan is re-deemed.\footnote{See id.} By creating legal innovations such as a shareholder rights plan or other defensive measures, a lawyer can minimize the controllable risk to a target corporation in connection with a hostile, suboptimal takeover bid.
IV. CONTINGENCY-BASED M&A FEES

In a transaction where there is a high level of risk controllable by the lawyer, and both parties are risk averse, Cheung’s analysis tells us that it makes sense for a client and its lawyer to agree to a share contract: a contingency-based M&A fee. Lawyers should want to—and their clients should want them to—put some skin in the game. Just as we see wide diversity in the share contracts employed in agricultural settings, we might also expect to see wide diversity in contingency-based M&A fee contracts. In this Part, I propose two basic models for contingency-based legal fees—pure success fees and fixed-plus-premium fees—each of which has two possible variants. By understanding the advantages and disadvantages of each variant, parties can negotiate the contract that is most appropriate to their particular circumstances.

A. PURE SUCCESS FEES

A pure success fee provides for payment of legal fees that are a percentage of deal consideration if and only if a transaction closes. Thus, the entire payment from client to lawyer is contingent on a successful deal outcome. This type of contract has two possible variations: percentage-of-total and percentage-of-surplus. In a percentage-of-total fee agreement, lawyers are paid a preset percentage of the total deal consideration if the transaction closes. The final fee is determined by multiplying the applicable percentage (or percentages) by the total value of the deal. This method is similar to how fees for investment banks are determined if a deal closes. For example, consider a transaction where the purchase price is $100 million and the parties have agreed to legal fees as determined by the Lehman Scale. In that case, the legal fees would total $1.1 million in the event of success. If the deal were to fail, the law firm would be paid nothing.

In contrast, in a percentage-of-surplus fee agreement, the lawyers will be paid a larger, preset percentage of the economic surplus generated to their client from the deal if the transaction closes. This is determined on the buy side by subtracting the purchase price from the buyer’s valuation and multiplying the difference by the applicable percentage. On the sell side, the opposite happens: the seller’s reserve price (or other preset threshold) is subtracted from the final purchase price, and the difference is multiplied by the applicable percentage. For example, consider the same transaction as above. Assume, however, that the client and its lawyers have agreed in advance that no fee will be paid for a purchase price below $90 million, whereas any amount above $90 million will generate fees at a ten percent rate. In that case, the legal fees would total $1

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145. See supra section I.A.1.
146. See supra section I.A.
147. Recall that the Lehman Scale dictates decreasing percentages for higher purchase prices. See supra note 21 and accompanying text.
million for a completed transaction. Here as well, if the deal were to fail, the law firm would be paid no fees.

The percentage-of-total and percentage-of-surplus models, however, have potential downsides for both clients and lawyers. The client may have two concerns in negotiating a pure success fee contract: moral hazard and valuation. Moral hazard is the tendency for an actor to change her behavior in response to the presence of a contract.148 In a typical hourly billing arrangement, a lawyer has very little immediate financial incentive to ensure that her client completes a transaction. Because her legal bills are paid whether the transaction closes or not, a lawyer is able to give impartial advice to her client about whether it should proceed with the transaction on its current terms. Clients may be worried, however, that the presence of a pure success fee contract might cause the lawyer to change her advice or behavior. For instance, a lawyer might now be incentivized to advise her client to complete a transaction, even if the terms are no longer economically advantageous to the client, because the lawyer is concerned about being paid her fee.149

In addition, clients may be worried about proper valuation in the context of a percentage-of-surplus fee contract. The description above is deceptively simple; it assumes that a client is able to perfectly value the company it is acquiring. In reality, valuation is a much more difficult—and much less precise—task.150 The risk of undervaluation may represent a significant concern to clients who are considering utilizing a percentage-of-surplus contract. If the client undervalues the target company in the above example by setting the threshold at $80 million instead of $90 million, the total legal fees become $2 million—twice as much for the same legal work and the same acquisition. This is similar to the challenges posed in negotiating contingency fee arrangements.151 This valuation risk can be mitigated somewhat, but lawyers will nonetheless have ongoing incentives to push their clients towards lower ex ante valuations when negotiating the terms of a percentage-of-surplus contract.

A lawyer who agrees to a pure success fee also will have concerns, including undercompensation, adverse selection, and cash flow. First, a lawyer may worry that he will not be adequately compensated for a favorable agreement because not all negotiation “wins” are reflected in the final purchase price, and she is being paid based on that price. For example, some of the key terms of an M&A agreement include the period of time that the escrow fund will exist,152 the

149. See Rapoport, supra note 48, at 283 (“[I]f success fees tend to create incentives to flip a company or its assets quickly . . . are those success fees such a good idea in terms of . . . policy?”).
150. See Richmond, supra note 49, at 5.
extent of the “knowledge group” in a representation or warranty,153 and a “best efforts’ clause” in a deal with a regulatory covenant.154 Even if the lawyer capably represents her client and achieves the desired outcomes in these areas, none of these outcomes will necessarily have a direct effect on the purchase price. In fact, the purchase price may be unfavorably adjusted to compensate for these “wins.” These agreements on important issues are not easily translated into monetary terms, so a lawyer on a pure success fee contract may feel like she is at risk for undercompensation.

Second, a lawyer may be worried about adverse selection when a client suggests that she utilize a pure success fee contract. Adverse selection is a problem of informational asymmetry. It “occurs when [a client] possess[es] substantially more information than [its lawyer] about the level of risk the [transaction] pose[s].”155 In the context of a pure success fee, a lawyer might be worried that a client who proposes such a contract is not committed to completing the transaction—the client now has no skin in the game. A client who pushes for a pure success fee may desire such an arrangement because it knows that the transaction is unlikely to be completed, but by utilizing such a fee structure, it will not have to pay for any legal work unless the deal closes. This is obviously distasteful to a lawyer. As a result, lawyers are likely to be wary of clients who are zealous about using a pure success fee, unless the client is able to demonstrate its legitimate reasons for wanting that type of fee agreement.156

Finally, a law firm may feel that entering into a pure-success-fee contract represents a threat to its business by impairing its cash flow and ability to make overhead payments. Though partners are paid on a less regular basis, law firms require significant, regular outlays for expenses such as salaries, rent, travel costs, and equipment.157 Payment via success fee is likely to be challenging for law firms because such payments are by definition irregular and unpredictable. This can pose a problem for a law firm that needs to make regular payments to employees and vendors. Especially in a firm that does not have extensive cash reserves or lines of credit, such irregular cash flow may prove fatal to the use of pure success fees in M&A transactions.


156. Cf. Molot, supra note 151, at 389 (“There are essentially two reasons why defendants might seek to get rid of their litigation risk, and a potential risk bearer deciding whether to assume litigation risk would want to know: Is the defendant seeking to give me the risk because it thinks it can do better with me than it will with the plaintiff? Or is the defendant seeking to give me the risk because it has a valid business reason for trying to dispose of it and is willing to pay a premium to dispose of it now?”).

157. See Brennan, supra note 95.
Both the percentage-of-total and percentage-of-surplus models, however, hold significant promise for both clients and lawyers. A client may desire a pure success fee for three primary reasons: to align incentives, to reduce monitoring costs, and to tie expenses to income. When a lawyer is working on a pure-success-fee contract, her compensation is directly linked to her client’s economic outcome in the deal. Therefore, her strongest incentive is to negotiate a deal for as much (on the sell side) or as little (on the buy side) consideration as possible. This incentive aligns perfectly with her client’s objective, which is precisely the same outcome. This is the most basic and intuitive case for pure success fees—such fees do an excellent job of aligning a lawyer’s incentive with her client’s. No longer does a client have to worry about whether its lawyer is acting self-interestedly to the client’s detriment; a pure success fee deals with this concern.

The reduced worry of self-interested behavior leads to the second major advantage of a pure success fee for a client: reduction in monitoring costs. When a client no longer has to worry about being taken advantage of by its lawyer, it can reduce the resources it devotes to monitoring its lawyer. It now does not have to spend valuable time and energy scrutinizing legal bills. Instead, the client can be much safer in its knowledge that its lawyer will only take actions that will redound to the client’s benefit. This reduction in monitoring costs generates real economic value for the client and may be a strong incentive to utilize a pure success fee.

The final major advantage to a client is that a pure success fee ensures that the client only has to pay legal fees when it has completed a transaction that is presumably expected-value positive. Psychologically, this can be a major benefit for a client. A client is likely to be satisfied with either paying no legal fees or significant legal fees for a significant transaction, but may balk at paying significant legal fees for no transaction. Though this benefit is intangible, it may be attractive to clients who are frustrated with costs and view lawyers merely as cost centers.

Lawyers will see two primary advantages to pure success fees: a larger reward for higher risk and a decreased focus on billing a large quantity of hours. When lawyers agree to a pure success fee, they are taking on increased risk in exchange for increased reward—they have skin in the game. The theory behind share contracts dictates that this is a mechanism for spreading risk among parties. In this case, this risk to lawyers is the prospect of no fees even though work has been done. By taking on greater risk than they otherwise would, lawyers will expect greater reward. This comes in the form of larger fees, on average, and flows from the teachings of the capital asset pricing

158. See Richmond, supra note 49, at 5 (“Clients ‘flyspeck’ bills because lawyers often do a poor job of crafting time entries or insist on block billing rather than itemizing their time by task.”).
159. See Herd & McManus, supra note 84, at 5.
160. See Cheung, supra note 9, at 27.
model. Lawyers desire greater returns; one lawyer writes that “lawyers’ increasing willingness to consider alternative fee agreements has much to do with their economic ambitions. Many lawyers believe that they can practice more profitably by moving away from the billable hour—benefits to clients are simply an additional justification.”

Finally, lawyers recognize that a decreased focus on the quantity of hours billed and attendant increase in quality of life are significant advantages to the pure success fee model. The obsession with billing increased hours in general, and its detrimental effects on young lawyers in particular, has recently been a topic of major concern to the bar. A pure success fee would mitigate these effects significantly. Instead of focusing purely on how many hours she can bill, a young lawyer now must ask herself if the action she is about to take will have a positive expected value for her client relative to the time required; if it does not, she should not take such an action. The focus will shift from quantity to quality—a welcome change for junior associates and senior partners alike and a strong incentive to move toward a success-based model.

B. FIXED-PLUS-PREMIUM FEES

A fixed-plus-premium legal fee is a contract that has two components: a fixed, guaranteed element that is earned as work is done; and a variable, contingent element that is earned only if a transaction is completed and is based on the total value of the transaction. This type of contract could come in two potential varieties: an hourly-plus-small premium contract or a retainer-plus-large premium contract. In an hourly-plus-small premium share contract, the client agrees to pay its lawyer based on the hours actually worked, with a small premium for completing the transaction. The hourly rate may or may not be discounted, and the small premium may be variable or preset. This is only a small deviation from the traditional hourly fee model but has a slight “share” component that may help better align incentives. Some firms already use such a model. For example, consider a transaction with a purchase price of $100

162. Richmond, supra note 49, at 5.
163. See Jeff Bleich, Escaping the Billable Hours Trap, CAL. ST. B.J. (Apr. 2008), http://archive.calbar.ca.gov/%5CArchive.aspx?articleId=91042&categoryId=91121&month=4&year=2008 (“That means less sleep, fewer outside interests, less commitment to loved ones and the crumbling of a decent life....An entire generation of lawyers has come to believe that their worth as a lawyer is measured not in how they solve problems but in how many hours they need to work.”).
164. See Matt Levine, M&A Is Just Too Easy, DEALBREAKER n.2 (Nov. 8, 2012, 3:16 PM), http://dealbreaker.com/2012/11/ma-is-just-too-easy (“I enjoyed [doing M&A deals] and recommend it to anyone with a few thousand hours a year to kill.”).
million. On average, legal fees for that transaction may be around $500,000. The parties may negotiate a success premium of $50,000, leading to total legal fees of $550,000 if the deal is successful. Here, the hourly fees represent the bulk of the total, while the success premium is small in relation to the total fee. If the deal were to fall through, the fees would total $500,000.

On the other hand, consider a retainer-plus-large premium model, similar to what many investment banks use today in connection with M&A deals. In this model, a client may pay a small retainer to its legal counsel at the outset of the engagement, with a large success premium payable upon completion of the transaction to be set off against the retainer. Consider the same transaction as above with a purchase price of $100 million. A retainer-plus-large premium fee would call for a small retainer—perhaps around $50,000—with either a percentage-of-total or percentage-of-surplus success premium (though perhaps at a lower rate). A percentage-of-total premium of one percent would generate legal fees of $1,000,000 for a successful transaction and of $50,000 for an unsuccessful transaction.

The primary disadvantage to the client of a fixed-plus-premium M&A contract is that it still has to pay at least some legal fees even if the transaction is ultimately unsuccessful. This is the primary problem with hourly billing, and the hope of a share contract is that it would address precisely this issue. Of course, it is much less of a problem for the retainer-plus-large premium than for the hourly-plus-small premium arrangement, but in both cases a client has to pay for legal work done on a transaction that ultimately was unsuccessful. This can damage lawyer–client relations and may cause a client to engage in fewer transactions.

A fixed-plus-premium M&A contract provides many advantages to both a client and its lawyers. For the client, it has the benefits of a reduction in moral hazard and a built-in discount. For lawyers, fixed-plus-premium contracts have lower variability in income and decrease adverse selection by clients. Fixed-plus-premium contracts reduce the moral hazard behavior by lawyers that is associated with both hourly billing and pure success fees. An hourly billing contract incentivizes lawyers to bill as many hours as possible. In contrast, a pure success fee incentivizes lawyers to close deals as often and as quickly as possible. Neither of these are optimally desirable for clients. Instead, by utilizing a fixed-plus-premium contract, a client can assure its lawyer that she will be paid some amount regardless of the outcome, but make it in the lawyer’s interest to only take actions that will produce a positive expected value for the client. This balance deals with the moral-hazard problem by making lawyers put

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168. See supra section I.A.
some, but not all, of their skin in the game. Clients are likely to find they have better outcomes when lawyers are freed from the strictures of maximizing fees and can focus on being trusted advisors and advocates.

In addition, the fixed-plus-premium model builds in an automatic discount for clients. As noted above, lawyers will sometimes reduce hourly fees for an unsuccessful transaction. However, this is irregular and uncertain. By entering into a fixed-plus-premium contract, clients can ensure that they will receive a guaranteed fee discount for an unsuccessful transaction. This benefit is financial, but also engenders goodwill between lawyers and clients.

Finally, a fixed-plus-premium contract has two primary advantages for lawyers: lower variability and a decrease in adverse selection. In either variety of a fixed-plus-premium contract, a lawyer is ensured payment of at least some fees in connection with every transaction. This mitigates the cash flow problem posed by a pure-success-fee contract. These contracts allow law firms to engage in more certain financial planning while decreasing liquidity concerns. Finally, there will be less frustration directed at a client who fails to complete a transaction because the lawyer will have some income regardless of the result of the transaction. This decrease in variability represents a significant benefit to law firms, which have traditionally been regarded as staid and conservative, but would like to capture the potential upside of large contingent-fee transactions.

Fixed-plus-premium contracts benefit lawyers by decreasing adverse-selection behavior by their clients. When clients must pay an upfront retainer, they are unlikely to ask their lawyers to pursue transactions that have a low likelihood of success. Thus, lawyers can feel more certain that when a client asks them to take a fixed-plus-premium matter, it is not because the deal is likely to be unsuccessful, but because there are legitimate advantages to the client in doing so. Because adverse selection and variability are two of the major risks to lawyers in taking contingency-based fees, a fixed-plus-premium contract that can mitigate these two risks is likely to be an attractive arrangement to deal lawyers. In fact, it is this precise arrangement that Time Warner and Cravath agreed to, as described at the outset of this Note.

**CONCLUSION**

As so often is true, “what’s past is prologue.” The Time Warner–AOL merger did not end well for Time Warner or AOL. In 2002, the combined AOL Time Warner was forced to report a loss of $99 billion—at the time, the largest write-down ever. In the end, both parties lost. The then-CEO and chairman of

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170. See supra section I.B.
171. See Furlong, supra note 79.
Time Warner, Jeff Bewkes, has called the merger “the biggest mistake in corporate history.” The only party that won was Cravath. Because the merger closed, it collected a $35 million contingent fee—one of the largest M&A legal fees ever.

The existence of occasional contingent-fee M&A agreements shows that there is some desire for such an arrangement, however weak. Lawyers and their clients may be hesitant to pursue this path for a number of reasons, including tradition, ethics, or fear. One reason that should not intimidate them, however, from reaching economically optimal contracts is the inability to identify when such a contractual form is appropriate. This Note has laid out the specific conceptual and real-life circumstances under which contingent-fee contracts make sense for M&A transactions. Lawyers and clients conducting M&A transactions should prefer share contracts—that is, contingency-based contracts—when both parties are risk averse and when there is a high level of lawyer-controllable risk stemming from substantive tax, antitrust, and corporate law concerns. Though these areas are not always fully controllable by lawyers, and government authorities and other market participants will have some impact, these areas of risk are far more controllable by lawyers than by their clients. By utilizing the lessons of this Note as a jumping-off point, attorneys and clients can begin to enter into such contracts to lower costs, share risk, and accomplish worthwhile and beneficial mergers and acquisitions.