CONDITIONAL AND CONTINGENT FEES: A SURVEY OF SOME RECENT RESULTS

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A. Introduction

In a typical tort case in the United States the plaintiff's attorney receives his compensation in form of a *contingent fee*. Under this payment scheme the attorney gets a share of the judgement if his client wins and nothing if his client loses. A common practice is to use a sliding scale: the attorney gets one-third if the case is settled without trial, 40% if the plaintiff wins at trial, and 50% if a judgement for the plaintiff is affirmed on appeal.

Contingent legal fees are widely used in the US. In a well-known empirical study, Kritzer (1990) observes that individual litigants tend to use contingent fees. In around 87% of all torts and 53 % of all contractual issues plaintiffs retain their lawyer on a contingency basis.

In Europe contingent legal fees were strictly forbidden: *Pactum cuota litis* is not allowed by the ethical code of the European Association of Lawyers. Nevertheless, market pressure has led some countries to allow conditional fees. Under *conditional fees* the lawyer gets an upscale premium if the case is won and nothing if the case is lost. The upscale premium is not related to the adjudicated amount. The United Kingdom started introducing conditional fees in the nineties, followed by Belgium and the Netherlands; the latter is now considering to formally allow contingent fees. Spain, France, Italy, and Portugal are considering the introduction of conditional fees. Germany has also relaxed some restrictions by means of third party contingent contracts, though not to the extreme of accepting conditional fees; see Kirstein and Rickman (2004). In Greece contingent fees of up to 20% as well as conditional fees are permitted.[1]

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[1] The conditional fee is usually nothing if no recovery is obtained. If the case is won, the solicitor gets his normal fees plus an uplift, or 'success fee', on top of the normal fees. There is a statutory limit of 100% on the uplift. Whether the uplift is actually related to the amount adjudicated in the United Kingdom is a matter of debate. The Law Society first recommended that the client's liability to the lawyer should be capped at 25% of any damages recovered; later it dropped the recommendation. See, e.g., Yarrow (2001). In class action suits yet another type of contract is used resembling conditional fees. Under the loadstar fee, contingent on class victory, the attorney receives a fair compensation for the time spent on the case multiplied by a factor reflecting

Accordingly, in quite a few countries contingent and conditional fees coexist. As mentioned before, in the US in torts 87% of individual plaintiffs retain their lawyer under contingent fees. By contrast, 88% of organizational litigants use hourly or flat fees, often with a bonus for performance, i.e., conditional fees (Kritzer 1990).[2]

Both contingent and conditional fees pay for performance by compensating the lawyer by a higher fee if the case is won. The main difference between contingent and conditional fees is that the former pays a percentage of the judgement whereas the latter pays a reward that is unrelated to the adjudicated amount.

In this paper we survey the literature analyzing the virtues of conditional and contingent views. After having reviewed the earlier literature, we then focus on three recent contributions to the subject.

B. Review of the earlier literature

Previous literature has mostly addressed the virtues of contingent legal fees, but has ignored the possibility of conditional legal fees. Contingent fees may be seen as a mechanism to finance cases when the plaintiff is liquidity constrained and capital markets are imperfect. Similarly, they may be used by the attorney and her client to share the risk generated by the case efficiently. See, e.g., Posner (1986).

Another explanation is related to the use of contingent legal fees in class-action litigation (Lynk, 1990, Klement and Neeman, 2004) and third-party involvement in litigation, such as insurance companies (Kirstein and Rickman, 2004).

The other explanations for contingent fees are all based on asymmetric information between the lawyer and his client. Contingent fees can be used to address a moral hazard problem: If the client cannot observe the attorney's effort, then tying the attorney's fees to the trial's outcome provides better incentives to exert efficient effort than hourly fees which tend to induce shirking (Danzon, 1983; Halpern and Turnbull, 1983; Gravelle and Waterson, 1993; Polinsky and Rubinfeld, 2003; Emons and Garoupa, 2006).

Rubinfeld and Scotchmer (1993) suppose that the attorney has better information about his ability and the plaintiff has better information about the merits of her case. A high-quality attorney will signal his ability by working for a high contingency percentage and a low fixed fee. A client who has a high-quality case will be willing to pay a high fixed fee and a low contingency percentage, while a client with a low-quality case will prefer a low fixed fee and a high contingency percentage.

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the degree of risk and the quality of work. By contrast to the output-based contingency fees, the loadstar method is input-based.

[2] In private correspondence Bert Kritzer was concerned to use the term contingency fees to refer to percentage fees and to use conditional fees to refer to U.K. style contingency fees: conditional fees are contingent on the outcome, and hence are contingency fees; the term conditional fee is rarely used in the U.S. for this type of

Dana and Spier (1993) and Emons (2000) look at the role of the attorney as an expert. Clients do not know the merits of their case. The attorney as the expert finds out about these merits. In Dana and Spier (1993) the lawyer recommends whether to pursue or drop the case; they conclude that the optimal compensation scheme will pay the attorney a share of the plaintiff's award. In Emons (2000) the attorney recommends how much work to put into the case; he finds that paying the attorney by the hour is generally better than using contingent fees.

The economic literature on conditional fees (Maclean and Rickman, 1999; Gray et al, 1999, Rickman et al, 1999, Yarrow, 2001; Fenn, 2002) has been concerned with the impact on the outcome of legal cases and the effects on the demand and supply of legal aid. Before-the-event legal cost insurance has been stifled by the existence of legal aid. When the government withdrew legal aid for many types of cases, conditional fees have moved to the fore along with after-the-event insurance policies, purchased after an actionable event from legal cost insurers.

C. The client has private information about her case

In Emons (2007) we compare conditional and contingent fees in a set-up where the client has private information about her case.

We consider two scenarios. In the first scenario clients have cases with different expected adjudication but the same risk; as a shortcut we will use the term merit for the expected adjudication. In the second scenario all cases have the same merit but differ in risk. Clients hire an attorney to take their case to court. Attorneys engage in Bertrand competition. Clients know the characteristics of their cases whereas lawyers do not. The client might be better informed than her attorney about the facts of her case; see Rubinfeld and Scotchmer (1993).

We do not allow for contracts with payments from the attorney to the client. We thus rule out the possibility that the lawyer buys the case from the client and we do not allow for penalties the lawyer has to pay to the client if the case is lost. This restriction follows from the *champerty doctrine* in the US and the UK and the forbidden *pactum cuota litis* in continental Europe.

Attorneys strategically choose how much effort they put into a case. Therefore, contracts have to be high-powered to provide incentives for high effort. More precisely, contracts may not entail fixed wages; the lawyer gets nothing when the case is lost. Accordingly, in our setup a contingent fee is simply given by a share of the adjudicated amount the attorney gets when the case is won; a conditional fee is given by a fixed amount for the lawyer if the case is won. Under both contractual forms the lawyer gets nothing if the case is lost. With asymmetric information about the merits, only a conditional fee contract is offered in equilibrium. This

contract. While we share his concerns, we nevertheless use the term conditional fee because it is well established in Europe.

contract induces high effort and lawyers just break even. To see this, suppose that a contingent and a conditional fee contract are offered simultaneously. Then clients with strong cases prefer the conditional fee because they need not share the residual returns. By contrast, clients with weak cases prefer contingency fees because the attorney's share is lower than the conditional fee. If a lawyer offers a contingent fee contract, he only attracts low merit cases; the lawyer thus gets a negative selection of all cases. The expected returns of this contract do not cover the attorney's cost of effort so that he will not offer it in the first place.

With identical merit and asymmetric information about risks, only a contingent fee contract is offered in equilibrium. This contract induces high effort and lawyers just break even. If a contingent and a conditional contract are offered simultaneously, high risk clients prefer the conditional fee and low risk clients prefer the contingent fee. To see this note that high risk cases have high stakes but a low probability to prevail. Under conditional fees the lawyer does not participate in the high stakes; he gets a fixed amount if the case is won. The expected returns of the attorney are, however, decreasing in risk. By contrast, under contingent fees the lawyer's expected share is constant and independent of risk. Since the lawyer gets a fraction of the outcome, under contingent fees he is compensated for a low probability to prevail by a high reward if the client wins. Low risk clients prefer contingent fees because for them a share of the outcome is less than the conditional fee that they are very likely to pay. If a lawyer offers a conditional fee contract, he attracts only high risk clients; the lawyer thus gets a negative selection of all cases. The expected returns of this contract do not cover the attorney's cost of effort so that he does better not offer it in the first place.

If we argue that when a plaintiff retains her lawyer, the probability to prevail and the amount at stake are unknown, we are in the scenario with asymmetric information about risk. We then explain the observation that in torts 87% of individual plaintiffs retain their lawyer under contingent fees. Insurance companies are mostly defendants. When the defendant retains her lawyer, a case is more developed; suppose the probability to win is known and only the amount at stake remains to be determined so that we are in the scenario with asymmetric information about merits. Then we explain the fact that 88% of organizational litigants, typically insurance companies, use hourly or flat fees, often with a bonus for performance, i.e., conditional fees.

Our results should become clearer once we draw the analogy between contingent and conditional fees (without fixed wage components) and equity contracts and standard debt contracts (without collateral) to finance risky projects. Our cases are risky projects as are the investment opportunities of entrepreneurs. Entrepreneurs need capital from investors; our clients need effort from lawyers. Capital/effort is lost when the project fails/when the case is lost.

Under equity finance the investor gets a share of the project's returns. So does the attorney under contingent fees. Under a standard debt contract the investor gets a fixed payment (interest plus principle) in non-bankruptcy states and nothing in bankruptcy states. Under conditional fees the attorney gets a fixed premium if the case is won and nothing when the case is lost. Accordingly, contingent and conditional fees generate the same payoff structure as do equity and standard debt finance.

Our results are thus related to the literature on adverse selection in credit markets, starting with Stiglitz and Weiss (1981). We derive an extended version of a result by De Meza and Webb (1987): they show that with asymmetric information about returns, investors prefer debt over equity; if there is asymmetric information about risk, investors prefer equity over debt.[3]

D. The attorney as the client's agent

In Emons and Garoupa (2006) we compare contingent and conditional fee arrangements in the following simple principal-agent set-up. A client hires a lawyer. After they have signed the contract, the lawyer learns the amount of adjudication if the case is won. Then the lawyer strategically decides how much effort she puts into the case: the more effort, the higher the probability of winning the case. Effort is not observed by the client. If, e.g., the lawyer were paid a fixed fee, he would provide no effort.

We find that both contingent and conditional fees give the lawyer an incentive to provide effort. Under conditional fees the upscale payment is not related to the adjudicated amount. Therefore, the lawyer's effort does not depend on the amount at stake. Under contingent fees the attorney gets a fraction of the judgment. He adjusts effort to the adjudicated amount: the higher the judgment, the more effort he puts into the case. Accordingly, under contingent fees the attorney uses his information about the amount at stake whereas under conditional fees he does not. Therefore, contingent fees are more efficient than conditional fees. This holds true independently of upfront payments to the lawyer being restricted to be non-negative or not.

Then we extend the model to the problem that under contingent but not under conditional fees the lawyer may have an incentive to drop the case once he learned the amount at stake. If upfront payments are non-restricted, the client gains from the option of dropping the case; when upfront fees are restricted to be non-negative, the lawyer gains and the client loses.

In this paper we analyze UK-style conditional and US-style contingent fees with respect to the incentives they give the attorney to work hard. Under contingent fees the attorney's effort is tied to the amount at stake; under conditional fees the effort choice is independent of the judgment. Because the attorney effectively uses his information about the adjudicated amount, contingent fees are more efficient than conditional fees. This holds true if upfront payments to the lawyer are restricted to be non-negative or not. To put it differently:

[3] De Meza and Webb assume pooling. A collateral is not used to screen entrepreneurs. In our model pooling is endogenous. The attorney's choice of effort rules out fixed wage components and thus any possibility to screen clients.

Looking at incentives, contingent fees are clearly better because the agent with more information becomes the residual claimant.

Our model also suggests that conditional fees could also do better than hourly and flat fees in the corporate market by providing a compromise between risk-sharing and incentives, saving on the need for in-house counsel to monitor external lawyers and reduce moral hazard.[4] Our conjectures, if correct, also indicate that if at some point contingent legal fees are allowed in Europe, they would replace conditional fees in personal litigation if providing incentives is the main issue. If, however, asymmetric information about the adjudicated amount is the major problem, conditional fees will be preferred over contingent fees as is the case if clients want lawyers to follow a safe litigation strategy (Emons 2006, 2007).

E. The risk-averse client seeks insurance

In Emons (2006) we compare conditional and contingent fee arrangements in a set-up where the attorney chooses the strategy on how the case is presented in the courtroom. There are two possible strategies, safe and risky, that affect the probability of winning as well as the amount adjudicated. A safe strategy provides a higher probability of winning with a lower adjudication. A risky strategy leads to a lower probability of winning with a higher adjudication. Overall, the expected judgement is higher for the risky strategy.

We show that the risk-neutral lawyer will play it safe with conditional fees, but will go for risk with contingent fees. Under conditional fees, the only contingencies of interest to the attorney is winning or losing, hence he has an incentive to maximize the probability of winning the case: conditional fees thus give the attorney the incentive to play it safe. Contingent fees condition not only on the events of winning or losing, but also on the amount of the judgment: the higher the judgment, the higher the attorney's share. The expected judgment is higher with the risky strategy, hence the lawyer plays it risky.

The client is risk-averse. She prefers the safe strategy if she receives the entire amount at stake, even though the expected judgement is lower. With this assumption we create a potential conflict of interest between the risk-averse plaintiff and her risk-neutral lawyer. The equilibrium contract maximizes the plaintiff's expected utility subject to the constraint that the lawyer gets his reservation utility. We are thus solving for the privately-optimal type of contract between the lawyer and client -- that which maximizes the expected utility of the client, given the usual constraint that the lawyer needs to be paid his reservation utility.

The client chooses conditional fees when lawyer's reservation utility is low; this result follows immediately from our assumption that the client prefers to play it safe when she gets the entire judgement. When the lawyer's reservation utility is, however, high, the client prefers contingent fees. Now the insurance function of contingent fees kicks in: When the law-

[4] Such a result seems to be supported by the observation that in the US many large law firms do operate on the basis of flat fee plus bonus for performance, rather than contingent fees (Kritzer, 1990; Garoupa and Gomez, 2008).

yer's reservation utility is high, his share of the judgement approaches one. The plaintiff is almost fully insured and no longer cares so much about the judgement risk; most of the judgement goes to the lawyer anyway.

In this paper we want to highlight two points. First, conditional fees give the lawyer an incentive to maximize the probability of winning the case. By contrast, under contingent fees the attorney maximizes the expected judgement. Second, if the plaintiff is risk averse, there may be a conflict of interest between the plaintiff and her lawyer. If the cost of hiring a lawyer is low, the plaintiff seeks insurance through conditional fees which induce the safe bet. If, by contrast, lawyers are expensive, the plaintiff prefers contingent fees, which shift most of the judgement risk to the lawyer.

We have solved for the privately-optimal type of contract between the lawyer and client -- the contract which maximizes the expected utility of the client given the constraint that the lawyer is paid his reservation utility. In the socially optimal allocation which maximizes the sum of the client's and attorney's utilities, the attorney bears all the risk. He chooses high effort and the risky strategy. This outcome is attained if the attorney buys the case from the client and becomes residual claimant. We have ruled out this possibility because of the *champerty doctrine* and the forbidden *pactum cuota litis*. We consider thus a second-best world in which the first-best is attained if and only if the lawyer's reservation utility is so high that the contingency fee is 100%.

One implication of the paper is that in a regime where conditional fees are allowed but contingent fees are forbidden, we should expect inefficient contracting for high costs of lawyering. Conditional fees do not allow for the sharing of the risk of a high or a low judgement. Compared to fixed wages they do, however, share the risk of winning and losing the case.

A second implication of the paper is the choice of lawyer fees as a response to the tension between plaintiff and lawyer concerning the litigation strategy. Therefore, an important aspect is how much control plaintiffs have over the choice of litigation strategy. Corporate clients usually keep a significant control over litigation, in part due to in-house legal counselling. For them the tension we analyze seems to be less of a problem. Individual clients usually lack the expertise to exert any significant control over their cases. For these clients conditional fees can be a useful means to induce a safe litigation strategy. To put it in terms of our example: a client can be assured that under conditional fees the lawyer behaves less aggressively than under contingent fees.

One argument against contingency fees is that they induce lawyers to settle cases too quickly. The attorney's return per hour invested in the case is higher if the case is settled rather than taken to court; see, e.g., Kritzer (2004). If we interpret the safe litigation strategy as going for a quick settlement, then this criticism applies even more to conditional fees.

F. Conclusions

We have seen that no contractual form dominates the other. When, for example, the client is concerned that the attorney might not work hard, she is better off with contingent rather than conditional fees. By contrast, if the client wants her lawyer to choose a safe litigation strategy, she should opt for a conditional fee contract.

Although in this survey we did not deal with hourly fees (task-based remuneration) the same result continues to hold when we add this contractual form to the picture: in certain situations hourly fees are better than contingent fees (Emons 2001); in other situations the reverse is true (Dana and Spier 1993).

The message we draw from these results is that there should be freedom of contract between the client and her lawyer: let them choose the contractual form that best suits their relationship. Attempts by the European Association of Lawyers to forbid conditional and contingent fees (*pactum cuota litis*) seem thus not motivated to protect the interests of the clients but seem to serve only the purpose of protecting the fiefs of attorneys.

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