

Conditional versus Contingent Fees (summary)*

*Winand Emons***

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.

Accordingly, in quite a few countries contingent and conditional fees coexist. 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). In

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this paper we want to analyze what determines whether clients choose contingent or conditional fees.

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 not related to the adjudicated amount.

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.

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 quota 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 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.

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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 are 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 (American Economic Review 1981). We derive an extended version of a result by DE MEZA and WEBB (Quarterly Journal of Economics 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.

Discussion

(moderated by Christian Kirchner)

CHRISTIAN KIRCHNER

I think that was a very interesting group of presentations under general the topic, “The Current Research Topics in Law and Economics”. It was also about methodological issues, about how to apply law and economics. We have seen 2 different worlds: the economic rationales of decision within rules and the rationales of decisions on rules. But, I do not want to ask my own questions, I want to hear your questions as well as your comments on the discussion itself. The floor is open.

VICTOR GOLDBERG

Just a brief question about the last paper. I was surprised that as it was ...in the model, the attorneys can't affect the award at all. It seems to me that one reason for a contingent fee is that we want the attorney to have some incentive to increase the size of the pie. Is that a fundamental part of your model or am I dismissing something?

WINAND EMONS

If you want to, you can include something like that in the model but then your model gets too complicated. What I've tried here is to set up a very simple model just focusing on that point and getting my message across. So, here we have, as in the Rubinfeld Scotchmer paper that the attorney has to choose effort and by choosing effort, he affects the size of the pie. So, I have this problem in this paper, but at a very simple level.

RONALD J. GILSON

This is another question for Professor Emons. The exercise that we are going to go through now is what happens when you write models because the next

move by the lawyers is “Let’s complicate the models”. The question I have is, you are essentially writing this as a one sided model, but of course it is a 2 sided moral hazard story. There is asymmetry about the quality of the claim and there is also asymmetry about the quality of the lawyer. To solve the problem of both the terms of the contract but then allocation of the lawyers by skill, we have to solve both sides of the dual moral hazard problem. Do you have intuitions about how the choice of fee signals information about the quality of the lawyer as opposed to just the information about the character of the distribution for the client?

WINAND EMONS

... This is the good thing about theory: You can focus on one problem and try to understand it. The message that I want to get across with this paper is “Hey listen. There is a huge literature out there on standard debt contracts and on equity finance. Contingent fees and conditional fees give rise to the same payoff structure and we can borrow a lot from finance literature”. This is essentially the point I want to make and I want to make it as easy as possible so that lawyers understand what I’m doing here.

ROBERT SCOTT

The second point taken is exactly right. The paper that I am writing...is simply asking the question...renegotiation, settlement, arbitration and the like. Before we have a complete theory of contract ..., we need to know more about how these alternative processes fit into the contract.

CHRISTIAN KIRCHNER

I have a question to Dan Rubinfeld: We have a discussion in the EU now to switch from public to private enforcement of European competition law. We have a similar discussion now in Japan. I would like to know, in your opinion, does it matter which kinds of contracts we have if we have networks of contracts so that parties are members of a network of contracts and under such circumstances, they might be anxious to use private litigation in the field of antitrust law or competition law and endanger their relationship with their contract partners?

DANIEL RUBINFELD

Can I have about 6 months to think about this? Let's assume we were considering a joint venture in which the parties have contracted to achieve some purpose. How does the system of private enforcement play on the incentives to form those joint ventures? It could play a significant role depending on how these network arrangements are designed and with the risk of private enforcement – that means that any member of this network has the possibility to sue others, perhaps using the antitrust laws as the basis for that suit. That could discourage the network from forming but also could make it harder to break up.

So, let me give you an example that I happened to be involved in, which is a striking example of the need to have good contracting. There was a joint venture many years ago between Air Touch and GTE, which are two large providers of cellular service. The joint venture was to enter into bidding for spectrum, which was auctioned off in the US to provide better cellular service. I still don't know today who wrote the contract that formed the joint venture, but the contract had 2 problems: One is that it had an agreement that if the arrangement broke up, both parties would agree for 99 years not to compete with the other, which raises antitrust issues. Second, it had a governance provision that said that in order for the break up to occur, both parties had to agree, which is a poor governance agreement. So, here's what happened: The joint venture never functioned terribly well. They bought Spectrum, but they never did function well together; at one point, the only person in the joint venture was a secretary who filled out forms. Other than that there was no active productive arrangement for the joint contract. However, the joint venture, did have a 99 year non-compete. So, when GTE decided to expand its network of cellular service and bid in new auctions for more Spectrum, GTE said "Well, I think we should break up this contract". Air Touch said, in effect, "That's interesting that you want to break it up. We prefer you not compete in our territories. We like the contract and we're going to vote to keep it in place. We're willing to pay the secretary to do the paperwork. But, if you want to pull out of the contract, you have to pay us; their demand was on the order of one billion USD. Eventually (as you might expect using law and economics), there was a settlement of this resolution, which led to significant benefits to Air Touch.

So, the answer to your question, is this an example in my view of a badly designed contract...it created huge incentives. Probably, had GTE thought this through, they would never have entered into the contract in the first place. There was an antitrust issue: The 99 year non-compete was almost certainly

anti-competitive in my view, but the net effect was probably to delay the break up of a joint venture that otherwise would have broken up of its own volition.

CHRISTIAN KIRCHNER

I'd like to go on to the 2nd question. Is it just the break of the contract or is that a typical example of ex-post opportunism – that we have contracting parties and then argue, ex-post, “We are not bound by that contract. This is an anti-trust matter.” And because of competition law being applied to that contract, it is void and then we can break up that contract.

DANIEL RUBINFELD

I agree with that, and that is why Robert Scott should answer this question. It is a great example of the need to look at both ends of the contract. It is a good example of ...if you are thinking about designing the contract at the beginning... they should have thought through all of these implications... It's a good example of where contracts and antitrust really go well together, and if these folks at GTE had spoken with Professor Scott, they certainly would have saved themselves a lot of money.

VICTOR GOLDBERG

I'd like to go back to Prof. Emons paper on contingent fees. One of the things that puzzles me is on the existence of class actions... The plaintiffs don't know anything because the lawyers are the ones bringing the suit, but they are essentially compensated with what amounts to a contingent fee, although it is sometimes renegotiated by the court. Why do they take that form under your theory?

WINAND EMONS

First of all, as far as I know, under class action they use the loadstar fee and this is actually a conditional fee. You are right. There, the informational asymmetry may be exactly the other way around. There are lots of papers out there looking at cases where the lawyer is better informed than the client. So, I would argue that if the legal problems are an issue, then it's more reasonable to assume that the lawyer has more information than the client. If the facts of

the case are an issue, then the scenario I look at makes more sense. I think that in reality, both scenarios make sense and I have simply looked at one of them and of course it makes sense to look at the others. You have to start somewhere so this is a starting point. I know that you lawyers always want everything in one model. We are not so good. (Laughter from audience)

DANIEL RUBINFELD

I want to add something related to the question just asked. One of the reason this is fun in the US is because judges like judge Posner are very interested in economics and in public policy, and in applying some of the ideas of law and economics. Here is another example: In these class action cases that we have in the US, a plaintiff's attorney technically represents members of the class, but really it is the lawyers who bring the lawsuits. There is a class representative, but most class members are barely acquainted with the case, other than getting a check at the end. So, the lawyer that brings the case, often under a contingency fee system, must, under federal court rules, go to the court to get the final fee payment arranged by the court. In many of these cases, the lawyers have been very well paid for their efforts, even though the ultimate clients do not really recoup very much. Interestingly, a number of judges, including Judge Walker in my jurisdiction in California, recognized that there is something inefficient about this. So, Judges have used their powers to institute auctions. They read some of the economics literature where the auction was suggested. ...

CHRISTIAN KIRCHNER

When it comes to asymmetry between plaintiffs and lawyers, it makes a difference whether you have a jury trial or not because at the moment, like in tort law, when you have a jury trial, then the uncertainty is normally with the lawyer.

More questions from the floor, please.

ISABEL STIRNIMANN (*audience*)

I'm Isabel Stirnimann. I'm a lawyer in Zurich and my question is for Prof. Rubinfeld. I'm an antitrust lawyer and I'm interested in what you told Ms. Kroes at this dinner party, and what – in a nutshell – were your recommenda-

tion for the European Community... how to set up the private litigation that is going to come.

DANIEL RUBINFELD

Well it was a short conversation but I actually told Commissioner Kroes that introducing private litigation did make sense for Europe for a number of reasons. I think there are some areas where greater deterrence is needed in anti-trust and the private litigation, appropriately provided, would be a good thing. But I did warn her that treble damages across the board for all violations is probably not a good thing. The idea of treble damages or double damages, using the Becker model of law and economics, is to induce proper deterrence for acts that would otherwise be undiscovered. There are many arrangements in antitrust (particularly vertical arrangements and some horizontal arrangements) that are obvious and discoverable and really shouldn't be coverable by treble damages. And then I was encouraging her to think carefully about the extent of discovery. It is my impression that in the US, we encourage a little too much discovery. It's very extensive; judges have great choice and usually would prefer to put off difficult decisions. But, basically, I think it is a good idea to move to a qualified private enforcement system, and it will also be good business for those of you who are practicing attorneys.

URS BIRCHLER, Swiss National Bank (*audience*)

Naively, one would think that spending more money for a lawyer would increase your chances of winning a trial. So if I'd like to empirically verify such a claim, I'd run into the difficulty that (as I have learned in the last half hour or so) that the better the case I have, the cheaper my lawyer works. So, is there a way to untangle these two opposite effects?

DANIEL RUBINFELD

Yes, you're right. First of all, in an hourly fee system and you spend more money, the lawyers would tend to balance each other off. But, what I've found, based on the work I've done, is that first of all in their fee arrangements, the better lawyers should recover more later on. So, the good lawyers eventually will be paid more because they will have a higher probability of winning. But they will get paid less up front and more towards the end if

they're plaintiffs' lawyers. I think ultimately the better lawyers do earn more money. Secondly, the lawyers who are more able are going to be more productive with the money they spend and will be able to make more use of the available evidence and all of that. That productivity will make it much more likely that they will be able to settle cases that are beneficial to their clients. So, I would expect to see more cases settled successfully by more able lawyers and a higher probability of winning at trial. And that evidence is certainly consistent with the theoretical work I've done and I think it is consistent with the empirical evidence that we have.

ERICH SCHANZE

There are two things that might eventually mitigate against private enforcement: that is really the other issue that we have discussed, the legal fees. If we don't get the legal fees side straight, the whole thing will blow up because if you get your payment in the ordinary German way, there will be industries created for doing particular things. It will be a fairly distorted game and that is of course one of the really critical things. The question is can we really adapt to a fee shift...

The other problem is, aren't we better off with partial industry regulation? I'm a great fan of partial industry regulation in the sense that the authorities do not have to step in everywhere. We only need occasional clean ups. The rules of the game are set up. I'm a great fan of that. It's an interesting alternative: Instead of having all these lawyers running around and starting lawsuits, we simply step in with some cases and that is more or less the signal that you ... adequate deterrence. There are no studies, actually, of looking at both systems which I've seen that are very convincing.

DANIEL RUBINFELD

Those are good comments. I'm not sure I'm convinced by that view but it would be a great study if we look at telecommunications because we've had various degrees of regulation in the US in telecommunications. The Telecom Act of 1996 was, in theory, an attempt to deregulate Telecom, but it really wasn't that; it just changed the nature of regulation. My impression is that it has not been terribly successful (I don't know if others disagree), so we'd have to look on a case by case basis.

CHRISTIAN KIRCHNER

Thank you very much to the speakers in this session and for the active participation from the floor. We're just in time for the coffee break. Thank you very much.