

# The Economics of US-style Contingent Fees and UK-style Conditional Fees\*

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## Abstract

Under contingent fees the attorney gets a share of the judgment; under conditional fees the lawyer gets an upscale premium if the case is won which is, however, unrelated to the adjudicated amount. We compare conditional and contingent fees in a principal-agent framework where the lawyer chooses unobservable effort after she has observed the amount at stake. Contingent fees provide better incentives than conditional fees independently of whether upfront payments are restricted to be non-negative or not. Under contingent fees the attorney uses her information about what is at stake more efficiently.

Keywords: contingent fees, conditional fees, moral hazard

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# 1 Introduction

In a typical tort case in the United States the plaintiff's attorney receives her compensation in form of a *contingent fee*. Under this payment scheme the attorney gets a share of the judgments if her client wins and nothing if her 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 judgment for the plaintiff is affirmed on appeal.

Contingent legal fees are widely used in the US.<sup>1</sup> In Europe the picture is quite different. Contingent legal fees are 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. This premium is not related to the adjudicated amount.<sup>2</sup> The United Kingdom started introducing conditional fees in the nineties followed by Belgium and the Netherlands, the latter now apparently considering to formally allow contingent fees. Spain, France, Italy, and Portugal are contemplating 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. The type of contract for legal fees has been changing rapidly all over Europe, clearly following the US tendency, but still not to the point of allowing contingent 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

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<sup>1</sup>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. By contrast, hourly fees are essentially used in divorce and other domestic issues.

<sup>2</sup>According to Kritzer (2004), a conditional fee is usually nothing if no recovery is obtained and pays up to twice the normal fee if there is a recovery. Whether the premium is actually related to the amount adjudicated in practice in the United Kingdom is a matter of debate; 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 the degree of risk and the quality of work. In contrast to the output-based contingency fees, the loadstar method is input-based.

of the judgment whereas the latter pays an upscale premium not related to the adjudicated amount.

We compare both 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, she 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. She adjusts effort to the adjudicated amount: the higher the judgment, the more effort she puts into the case. Accordingly, under contingent fees the attorney uses her information about the amount at stake whereas under conditional fees she 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 she 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.

The literature has mostly dealt with contingent legal fees<sup>3</sup>, but has largely ignored the possibility of conditional legal fees. As far as we know, this—together with two companion papers (Emons 2004a,b)—are the first attempts to provide an efficiency-comparison between US-style contingent and UK-style conditional fees.<sup>4</sup>

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<sup>3</sup>See, among others, Danzon (1983), Halpern and Turnbull (1983), Lynk (1990), Dana and Spier (1993), Gravelle and Waterson (1993), Rubinfeld and Scotchmer (1993), Emons (2000), Polinsky and Rubinfeld (2003), Kirstein and Rickman (2004), Klement and Neeman (2004).

<sup>4</sup>The economic literature on conditional fees is essentially UK-based; for a summary see Yarrow (2001). It studies the impact of conditional fees on the outcome of legal cases

Emons (2004a) compares conditional and contingent fees in a framework where lawyers are uninformed about the clients' cases. If there is asymmetric information about the expected adjudication of cases, in equilibrium attorneys will offer only conditional fees. If there is asymmetric information about the risk of cases, only contingent fee contracts are offered in equilibrium.

Emons (2004b) compares conditional and contingent fees in a framework where lawyers choose between a safe and a risky litigation strategy. Under conditional fees lawyers prefer the safe strategy, under contingent fees the risky one. Risk-averse plaintiffs prefer conditional fees over contingent fees when lawyering costs are low. With high contingent fees the plaintiff is well insured and does not care about risk: most of the surplus goes to the lawyer anyway.

In the next section we describe the model and derive our results. Section 3 concludes.

## 2 The model

A plaintiff has been a victim of an accident or a breach of contract. He sues the defendant to be paid damages  $J$ . With the purpose of being compensated, he hires a lawyer. The probability of winning  $p$  depends on the unobservable costly effort  $e \in [0, 1]$  exerted by the lawyer. More specifically, let  $p(e) = e^\gamma$ ,  $\gamma \in (0, 1)$ .<sup>5</sup> We thus assume  $p(0) = 0$ ,  $p(1) = 1$ ,  $p_e > 0$ ,  $p_{ee} < 0$ , and  $p_e(0) = "+\infty"$ . Effort increases the probability of prevailing, but at a decreasing rate. The lower  $\gamma$ , the higher the marginal productivity of effort for low levels of effort, and vice versa for high values of  $\gamma$ . For simplicity, the attorney's cost of effort is  $e$ .

When the case is won, the plaintiff gets  $J$  from the defendant whereas he gets nothing when the case is lost. The amount of adjudication  $J$  is the realization of a random variable with support  $[0, 1]$ , c.d.F.  $G$ , and expected value  $E(J) \in (0, 1)$ .

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and the effects on the demand and supply of legal aid.

<sup>5</sup>We need the example only for the welfare comparison in the case of non-negative upfront payments. For all the other results it is sufficient that the lawyer's effort choice can be identified by her first-order condition.

The timing of events is as follows. When the plaintiff and the attorney sign the contract, they know the set-up we have just described. Neither party knows the realization  $J$ . After the lawyer has accepted the contract, she learns the realization  $J$ .<sup>6</sup> Then she decides strategically on effort  $e$ ; effort is not observed by the plaintiff. The case is then won with probability  $p(e)$  or lost with probability  $(1 - p(e))$  and payoffs are realized.

We study two possible fee contracts between the plaintiff and the attorney:

**Definition 1** *A contingent fee contract  $S$  is described by a fixed component  $w$  plus a percentage  $\alpha$  of the adjudicated amount  $J$  if the case is won. Formally,*

$$S = \begin{cases} w + \alpha J, & \text{if the case is won;} \\ w, & \text{if the case is lost.} \end{cases}$$

**Definition 2** *A conditional fee contract  $K$  is given by a fixed component  $w$  plus a upscale fee  $d$  not related to the adjudicated amount  $J$  if the case is won. Formally,*

$$K = \begin{cases} w + d, & \text{if the case is won;} \\ w, & \text{if the case is lost.} \end{cases}$$

Under contingent fees the expected utility of the risk neutral attorney given  $J$  is  $V_S(J) = p(e)\alpha J - e + w$  and the expected utility of the risk neutral plaintiff is  $U_S(J) = p(e)(1 - \alpha)J - w$ . The ex ante expected utilities at the time of contracting are  $E(U_S) = E(p(e)(1 - \alpha)J) - w$  and  $E(V_S) = E(p(e)\alpha J - e) + w$ .

Under conditional fees the expected utility of the attorney given  $J$  is  $V_K(J) = p(e)d - e + w$  and the expected utility of the plaintiff  $U_K(J) = p(e)(J - d) - w$ . The ex ante expected utilities are  $E(U_K) = E(p(e)(J - d)) - w$  and  $E(V_K) = E(p(e)d - e) + w$ .

The ex post efficient level of effort maximizing the expected judgment minus the cost of effort satisfies  $p_e J = 1$  or in closed form  $e^*(J) = (\gamma J)^{1/(1-\gamma)}$ . The efficient level of effort thus increases with  $J$ : the more merit the case has, the higher should be the attorney's effort.

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<sup>6</sup>Although both parties know the nature of the case, there are many contingencies which preclude them from knowing the exact value of the recovery. Our assumption that there is an informational advantage on the side of the lawyer is plausible having in mind which party can better estimate the judgment at trial, but we acknowledge that in many contexts plaintiffs may hold private information. See Emons (2004a) for a model that looks at uninformed lawyers.

Let the plaintiff's reservation utility be zero and the lawyer's be  $v \in [0, E(J)]$ . Note that lawsuits with  $p(e^*(J))J - e^*(J) < v$  should be dropped since the expected value of the lawsuit is less than the opportunity cost.

## 2.1 Perfect information and imperfect but symmetric information

As points of reference, let us briefly consider the cases of perfect and of imperfect but symmetric information concerning  $J$ . If both parties know the realization of  $J$  at the time of contracting, contingent and conditional fee contracts are equivalent. Any  $d = \alpha J$  will produce the same type of incentives for the attorney to exert effort and the same risk allocation; the only risk is losing the case which is the same for both types of contracts.

Suppose neither lawyer nor plaintiff know the realization of  $J$  at the time the attorney chooses  $e$ ; both only know the expected value of adjudication to be  $E(J)$ . The two regimes are equivalent in solving the misalignment of objectives. Any  $d = \alpha E(J)$  generates the same type of incentive for exerting effort as contingent fees.

Nevertheless, the two regimes give rise to different risk allocations. Contingent fees are more risky than conditional fees for the lawyer, the opposite is true for the client. Suppose the attorney is risk neutral and the plaintiff is risk averse. This is typically true in the personal segment of the market for legal services but not in the corporate segment. Then a contingent fee contract is more efficient than a conditional fee contract: both are equally efficient in solving the incentive problem, but the former is better in achieving efficient risk-sharing than the latter. The opposite result will hold if lawyer is more risk averse than plaintiff.

## 2.2 Imperfect and asymmetric information

Let us now return to the situation where the lawyer knows  $J$  at the time of choosing effort but not the plaintiff. Under contingent fees the attorney maximizes  $V_S$  with respect to  $e$ . The choice of effort will satisfy  $p_e \alpha J = 1$  or in closed form  $\hat{e}_S = (\gamma \alpha J)^{1/(1-\gamma)}$ . Under conditional fees the lawyer maximizes  $V_K$ ; here optimal effort satisfies  $p_e d = 1$  or  $\hat{e}_K = (\gamma d)^{1/(1-\gamma)}$ .

Under contingent fees effort  $e$  varies with  $J$ ; under conditional fees effort is independent of  $J$ .

### 2.2.1 Optimal Contracts with no restriction on upfront payments

With no restriction on upfront payments under contingent fees the plaintiff maximizes with respect to  $(w_S, \alpha)$  his expected utility  $E(U_S)$  subject to  $p_e \alpha J = 1$  and  $E(V_S) \geq v$ . The optimal choice is  $\alpha = 1$ . The attorney becomes the residual claimant of the amount adjudicated: there is no problem of risk sharing, but a high-powered incentive contract is needed to solve the moral hazard problem. The fixed component  $w_S$  is negative. The lawyer buys the case at a price which puts her on her reservation utility.

Under conditional fees the plaintiff maximizes with respect to  $(w_K, d)$   $E(U_K)$  subject to  $p_e d = 1$  and  $E(V_K) \geq v$ . Here the optimal choice is  $d = E(J)$ . With a conditional fee it is impossible to make the choice of effort depend on  $J$ . Taking the average  $J$  as conditional fee implements the average effort level. The fixed component  $w_K$  is negative. The lawyer buys the case at a price which puts her on her reservation utility.

Contingent fees are efficient whereas conditional fees are not. The lawyer's effort maximizing total surplus satisfies  $p_e J = 1$ . Under contingent fees this is attained with  $\alpha = 1$ . However, under conditional fees, this is not possible because the upscale fee is not related to the adjudicated amount and has to be contracted before the plaintiff knows the exact value of  $J$ .<sup>7</sup>

Finally note that the lawyer is indifferent between the two fee schedules: by construction she gets  $v$ . The plaintiff does worst under conditional fees. Accordingly, if  $E(U_K) \geq 0$ , it is individually rational for the plaintiff to file suit under both fees.

### 2.2.2 Optimal Contracts with non-negative upfront payments

Consider now the scenario with the constraint  $w \geq 0$ . This restriction follows from the *champerty doctrine* in the US and forbidden *pactum quota litis* in Europe. Without this constraint under the optimal contracts the fixed salary

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<sup>7</sup>The superiority of contingent fees also follows from Holmström (1979). An optimal incentive scheme uses extra information if it is informative about  $e$ .

is negative: the attorney effectively buys the case from the plaintiff. If we impose  $w \geq 0$ , this constraint actually binds for both regimes.

We solve the problem for the plaintiff when  $w$  is zero so that both contingent and conditional fee contracts only have variable components.<sup>8</sup> We first solve the problem ignoring the lawyer's participation constraint. For the welfare comparison we use our example. Under conditional fees the plaintiff maximizes  $E(U_K)$  subject to  $p_e d = 1$ . The optimal solution is  $d = \gamma E(J)$ . The expected payoff for the client is

$$E(U_K) = (1 - \gamma)\gamma^{2\gamma/(1-\gamma)} E(J)^{1/(1-\gamma)}$$

whereas the attorney gets  $E(V_K) = \gamma E(U_K)$ .

Under a regime of contingent fees, the client maximizes  $E(U_S)$  subject to  $p_e \alpha J = 1$ . The optimal solution is  $\alpha = \gamma$  and the expected payoff for the client is

$$E(U_S) = (1 - \gamma)\gamma^{2\gamma/(1-\gamma)} E(J^{1/(1-\gamma)}).$$

The attorney gets  $E(V_S) = \gamma E(U_S)$ .<sup>9</sup>

Since  $J^{1/(1-\gamma)}$  is strictly convex, Jensen's inequality implies  $E(J^{1/(1-\gamma)}) > E(J)^{1/(1-\gamma)}$ . Accordingly, plaintiff and lawyer do better under contingent fees. Under contingent fees the attorney uses the information she has about  $J$  when choosing effort whereas under conditional fees she does not.<sup>10</sup> To summarize our results:

**Proposition 1** *If  $w \geq 0$ , plaintiff and lawyer do better under contingent fees than under conditional fees.*

First note that for the plaintiff it is always individually rational to sue. Next we need to check that the participation constraint for the lawyer is

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<sup>8</sup>Note that with  $w = 0$  contingent and conditional fees generate the same payoff structure as equity finance and a standard debt contract. If  $w > 0$ , conditional fees resemble a debt contract with a collateral; see Emons (2004a).

<sup>9</sup>The higher is  $\gamma$ , the more high-powered are the incentive schemes under both set of fees and the higher the lawyer's share of the surplus. To achieve the same level of  $p$ ,  $e$  has to be higher the higher  $\gamma$ . Accordingly, incentives have to be stronger the higher  $\gamma$ .

<sup>10</sup>With the restriction  $w \geq 0$  neither contingent nor conditional fees are in any sense optimal. The superiority of contingent fees doesn't follow from any result in the literature we are aware of.

satisfied in both cases. That is the case as long as  $E(V_K) \geq v$ . Let us assume that this condition is satisfied with strict inequality in order not to solve the model with a binding lawyer's participation constraint.<sup>11</sup>

Under both contracts the attorney obviously does better in the second scenario with  $w = 0$  than in first scenario without this restriction where she gets exactly her reservation utility  $v$ . For the plaintiff the opposite is true. Under both contracts the joint surplus is smaller in the second scenario than in the first one; the lawyer gets more. Accordingly, the plaintiff's expected surplus is less if  $w = 0$  than if we allow for negative upfront payments. This is a standard result for second-best contracts. Effort is distorted downwards because the principal faces the trade-off of reducing the agent's rent versus providing incentives.

### 2.3 Imperfect and asymmetric information when the lawyer can drop the case

In the previous section we have assumed that the participation constraint is solved before the attorney learns the realization  $J$ . Once  $J$  is revealed, the lawyer is stuck with the contract and she can only adjust her effort. The attorney cannot drop the case. Yet if  $J$  is small, under contingent fees the lawyer prefers to drop the case and earn  $v$  with the outside opportunity to investing  $\hat{e}_S$  and earn the (miserable)  $p(\hat{e}_S)\alpha J - \hat{e}_S$ .

To be more precise, we assume that the lawyer can drop the case at zero cost once she discovers the true value of  $J$  and before effort is chosen. The rule of "no damages" thus applies. First note that under conditional fees the attorney has no incentive to drop the case because her payoff  $p(\hat{e}_K)d - \hat{e}_k$  is independent of  $J$ .

Now consider contingent fees. The first scenario where the lawyer buys the case from the client is simple. Once the attorney learns that she better works elsewhere, she simply drops the case; her payment of  $(-w_S)$  is sunk at the time. This new option makes working on the case more attractive for the lawyer. If  $J$  is low, she turns to her alternative job and gets  $v$ . This in

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<sup>11</sup>If the participation constraint binds, the optimal  $\alpha > \gamma$  and  $d > \gamma E(J)$  so as to guarantee  $v$  for the attorney. Effort will go up, but the client will do worse because his share is lower.

turn allows the client to increase the price ( $-w_S$ ) the lawyer has to pay for the case. The attorney is indifferent as to whether she can drop the case or not; the client strictly prefers the latter option.

Next consider the second scenario with  $w = 0$ . If  $p(\hat{e}_S)\alpha J - \hat{e}_S < v$ , the lawyer drops the case and earns  $v$  elsewhere. Define  $\hat{J}$  to satisfy  $p(\hat{e}_S(\hat{J}))\alpha\hat{J} - \hat{e}_S(\hat{J}) = v$ . In terms of the example  $\hat{J} = (v/(1-\gamma))^{(1-\gamma)}1/(\alpha\gamma^\gamma)$ . Accordingly, for  $J \geq \hat{J}$  the attorney performs and for  $J < \hat{J}$  she drops the case.

The lawyer's expected utility is

$$E(V_S) = v \int_0^{\hat{J}} dG(J) + \int_{\hat{J}}^1 [p(\hat{e}_S)\alpha J - \hat{e}_S] dG(J) > v.$$

The plaintiff's expected utility is

$$E(U_S) = \int_{\hat{J}}^1 [p(\hat{e}_S)(1-\alpha)J] dG(J).$$

Increasing  $\alpha$  now has two effects on the lawyer's behavior: As in the preceding scenario it increases the attorney's effort. Moreover, now we have the additional effect that increasing  $\alpha$  increases the performance set  $[\hat{J}, 1]$ . Raising  $\alpha$  lowers  $\hat{J}$ , the judgment rendering the lawyer indifferent between pursuing and dropping the contract. Consequently, the optimal  $\alpha$  will exceed  $\gamma$ , the optimal value if the lawyer cannot drop the case. We may, therefore, conclude that the option of dropping the case makes the attorney certainly better off: whenever  $J$  is low, she turns to the outside job; when  $J$  is high, she earns more on the case because  $\alpha$  is higher. The client is certainly worse off. When  $J$  is low, he gets nothing because the case is dropped. When stakes are high he gets a lower share.

When the attorney can drop the case, the joint surplus is higher under contingent than under conditional fees: under contingent fees the lawyer uses this option whereas under conditional fees she does not. The lawyer is better off under contingent fees. Under which regime the client does better cannot be answered without specifying the c.d.F.  $G$ .

## 2.4 The role of risk-aversion

We have obtained our result that contingent fees are more efficient than conditional fees under the assumption that both players are risk neutral.

Contingent fees shift more risk from the plaintiff to the lawyer than conditional fees. Therefore, once we allow for the possibility that the plaintiff is less risk averse than the attorney, the superiority of contingent fees we have obtained does not necessarily hold.<sup>12</sup>

Conditional fees provide better insurance for the attorney. If she is sufficiently risk averse, the better risk allocation under conditional fees more than compensates the better effort incentives of contingent fees. By contrast, if the plaintiff is more risk averse than the lawyer, our result that contingent fees are more efficient than conditional fees is of course reinforced.

Conditional fees lead to more efficient risk-sharing if the plaintiff is less risk averse than the lawyer. This seems to be true in the corporate segment of the market for legal services, essentially contract and property litigation. This seems not to be the case in the personal segment of the market, that is, personal injury litigation. Thus, for the personal segment we may conclude that contingent fees are better for incentives and for risk sharing. However, in the corporate segment conditional fees can be better than contingent fees because the superior risk-allocation may outweigh the inferior incentives.

### 3 Conclusions

In this paper we have analyzed 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 her 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: Looking at incentives, contingent fees are clearly better because the agent with more information becomes residual claimant.

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<sup>12</sup>To see this consider, e.g., the case with no restriction on upfront payments. Let  $\gamma = .5$  and  $\tilde{J}$  be uniformly distributed on  $[0, 1]$ . The plaintiff is risk neutral; the attorney is risk averse with  $V = w^{-1} - e$  and reservation utility of zero. The optimal conditional fee is given by  $w_K = -.25(1/22)^{-2}$  and  $d = 1/22$ , generating utilities  $E(V_K) = 0$  and  $E(U_K) = (5/22)(1/22)^{-1} - w_K$ . The optimal contingent fee is  $w_S = -(5/24)(1/11)^{-2}$  and  $\alpha = 1/11$ , yielding  $E(V_S) = 0$  and  $E(U_S) = (50/231)(1/11)^{-1} - w_S < E(U_K)$ .

Our model also suggests that conditional fees could do also 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.<sup>13</sup> Our conjectures, if correct, also indicate that if at some point contingent legal fees are allowed for 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 2004 a,b).

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<sup>13</sup>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, 2004).

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