

Contingent Fees versus Legal Expenses Insurance*

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Abstract

We model a civil dispute as a contest with delegation. A credit constraint may be binding for a plaintiff, but not for a defendant. We first study the American practice of contingent fees, in which case a plaintiff's lawyer works on a contingent-fee basis but a defendant's lawyer on an hourly-fee basis. We next consider the European practice with legal expenses insurance, in which case the defendant may have to purchase a legal expenses insurance policy and both lawyers work on the hourly-fee basis. Comparing the American and European, we then show: (i) under the condition that moral hazard costs regarding lawyers' effort are not too great, the plaintiff prefers the European practice to the American one; (ii) the European practice incurs more legal expenses than the American one.

Keywords: Tort cases; Contingent and hourly fees; Credit constraints;
Legal expenses insurance

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1. Introduction

Litigation costs litigants a great deal of effort. To bring a case to a court, for instance, a plaintiff has to pay lawyer's fees, court fees, copying costs and witness fees. At the same time, she should also incur non-monetary effort – mostly her time spent. (Throughout the paper, we use "she" to refer to a plaintiff or a defendant, and "he" to refer to a lawyer.) Since some litigation costs such as court fees and (some) lawyer's fees must be paid in advance, a potential plaintiff who fails to finance the up-front legal expenses may be obliged to give up the lawsuit. But there are two ways to support such a plaintiff: contingent fees in the United States and legal expenses insurance in European countries where contingent fees are forbidden. Under a contingent-fee arrangement, a plaintiff's lawyer in the United States routinely charges one third of the award if his client wins and nothing if his client loses. On the other hand, the majority of European jurisdictions, where contingent fees are absent, have well-developed insurance markets for legal expenses (see van Velthoven and van Wijck, 2001; Heys, Rickman and Tzavara, 2004).

In some countries such as Korea and Japan, however, neither contingent fees nor legal expenses insurance exists.¹ Recognizing the importance of supporting credit-constrained plaintiffs, the Korean jurisdiction is now contemplating the introduction of contingent fees. A natural question is then which institution will serve the Korean and Japanese jurisdictions better, contingent fees or legal expenses insurance. To figure out the answer to this problem, we develop a contest model with delegation.²

This paper extends the delegation model of Baik and Kim (1997) to the case where a plaintiff's lawyer works on either a contingent-fee or an hourly-fee basis but a defendant's lawyer on the hourly-fee basis. We assume that the plaintiff, defendant and lawyers are risk-neutral. We first choose a model in which the plaintiff adopts the contingent fee for her lawyer (the American practice of contingent fees).³ To be more precise, our two-stage game runs as follows. In the first stage, knowing that the plaintiff adopts the contingent fee and the defendant the hourly fee, the plaintiff determines the contingent-fee fraction for

her lawyer and announces it publicly. In the second stage, the lawyers exert their effort simultaneously and independently to win the lawsuit. The plaintiff's lawyer chooses the effort level on his own, but the effort level of the defendant's lawyer is chosen by the defendant. The defendant has to incur a monitoring cost since she hires her lawyer under the hourly fee. The probability of winning for a party depends solely on the effort levels. We use logit-form litigation success functions.⁴

Next, we consider a modified model in which the plaintiff as well as the defendant adopts the hourly fee. We assume that the defendant (usually a firm) has no difficulty in financing her lawyer's hourly fee. We also assume that the plaintiff (usually an individual) may face a credit constraint but can purchase a legal expenses insurance policy (the European practice of hourly fees with legal expenses insurance).⁵

Comparing outcomes from the two models, we first demonstrate that, under the condition that moral hazard costs regarding lawyers' effort are not too great, the European practice brings the plaintiff more expected payoffs, compared to the American practice. We can explain this, using the fact that in the real world a corporate defendant with a deep pocket sticks to the hourly fee when both the contingent and hourly fees are available. Thus, if a government's objective is to increase expected payoffs of credit-constrained plaintiffs, the introduction of the European practice may be better than that of the American one.

We next show that the American practice incurs less legal expenditures than the European practice. The intuition behind this result is due to the delegation argument: A principal can benefit by using a delegate whose objective function differs from hers.⁶ Under the American practice, the objective function of the plaintiff's lawyer differs not only from his principal but also from that of the defendant's lawyer, which makes competing lawyers less aggressive. This implies that if the government's objective is to reduce the level of litigation costs, then the introduction of the American practice may be better than that of the European one.

The comparison shows that there is a trade-off between the introduction of the American practice and that of the European one. We therefore conclude that it depends on the Korean and Japanese jurisdictions' objectives which institution will serve them better – the American or the European practice.

At this point, we should note the relationship between this paper and the economic literature on contingent fees and legal expenses insurance. The literature on contingent fees has mainly emphasized informational asymmetry issues in a principal-agent framework. That is, contingent fees can be used to mitigate a moral hazard problem. Examples include Danzon (1983), Gravelle and Waterson (1993), Rickman (1999), Polinsky and Rubinfeld (2003), and Emons and Garoupa (2004). Contingent fees and legal expenses insurance may also be seen as a mechanism for a risk-averse plaintiff to shift the risk of incurring legal expenses. See, e.g., Posner (1998, pp. 624-32) for contingent fees, and Heys, Rickman and Tzavara (2004) for legal expenses insurance. In contrast, our contingent-fee model follows the conventional idea that contingent fees can be used to support a liquidity-constrained plaintiff. To make this point clear in the simplest possible way, we deliberately consider a model of perfect information and assume that litigants and lawyers are risk-neutral. But we admit an exogenously given moral hazard cost when hourly fees are used.

The paper proceeds as follows. In the next section we describe the basic model. Section 3 analyzes a contest model in which a plaintiff's lawyer works on a contingent-fee basis but a defendant's lawyer on an hourly-fee basis. Section 4 considers a modified model in which both lawyers work on the hourly-fee basis, and then compares outcomes from the two models. Section 5 offers our concluding remarks.

2. The basic model

Consider a tort case in which a plaintiff files a lawsuit against a defendant in order to receive compensation for damages. Each party hires a lawyer for the lawsuit. For concise

exposition, let us call the plaintiff player 1 and her lawyer agent 1, and the defendant player 2 and her lawyer agent 2. We then model this situation as a contest: Agents 1 and 2, representing players 1 and 2, respectively, expend their effort simultaneously and independently to win a prize (lawsuit). The agents' effort consists of monetary (such as filing fees and consulting fees of experts) and non-monetary components (such as the agents' time spent), though we make no distinction between the two components. The players and agents value the prize at V .⁷

Let x_1 and x_2 be the agents' effort levels in units commensurate with V and let p_1 be the probability that agent 1 wins. We assume that the litigation success function for agent 1 is:

$$\begin{aligned} p_1 &= x_1/(x_1 + x_2) && \text{for } x_1 + x_2 > 0 \\ &1/2 && \text{for } x_1 + x_2 = 0. \end{aligned} \tag{1}$$

The players and agents are risk-neutral. Their objective are to maximize their own expected payoff. The players choose between two possible fee contracts for their agents: (i) under a contingent fee contract, an agent receives the fee that is proportional to V if he wins and nothing if he loses; (ii) under an hourly fee contract, the agent's fee is based on his effort level, regardless of the outcome of the contests.

3. The contingent fee for the plaintiff's lawyer

To reflect the typical compensation structures for lawyers in the United States, we assume a contingent fee for agent 1 (the plaintiff's lawyer) and an hourly fee for agent 2 (the defendant's lawyer). The contingent fee frees player 1 from a possible credit constraint.

Agent 1's contingent fee is βV , where $0 < \beta < 1$. Since it is paid only if agent 1 wins the contest, there is no need for player 1 to monitor agent 1's effort level. In order to

use the hourly fee, however, it must be true that player 2 can observe agent 2's effort level; otherwise, she could not deal with his moral hazard. We thus assume that player 2 can observe agent 2's effort level x_2 by expending a monitoring cost of δx_2 , where $\delta > 0$. This monitoring cost implies that, if player 2 asks agent 2 to work more, then she should exert more effort to monitor the longer time. Thus, delegation costs player 2 a total amount of $(1 + \delta)x_2$. But there might be another way to describe it: The parameter δ could be used to denote a possible overcharge rate instead of the monitoring cost rate. Exploiting his informational advantage on x_2 , for instance, agent 2 could overcharge his fee by an amount of δx_2 . We assume that δ is exogenously given and publicly known.

We formally consider the following two-stage game. In the first stage, knowing that player 1 adopts the contingent fee and player 2 the hourly fee, player 1 determines the contingent-fee fraction for agent 1 and announces it publicly. In the second stage, agent 1 and player 2 choose the effort levels simultaneously and independently which agents 1 and 2 will expend, respectively. Note that agent 1 chooses the effort level on his own, but agent 2 does not. Because agent 2 is hired under the hourly fee, it is player 2 who chooses the effort level.⁸ After the agents expend their effort levels, the winner is determined, and the players pay compensations to their agents according to their contracts.

Let π_i represent the expected payoff for agent i . Then the payoff function for agent 1 is

$$\pi_1 = p_1 \beta V - x_1, \quad (2)$$

and that for agent 2 is $\pi_2 = (1 - \beta)x_2$.⁹ The payoff function for player 1 is

$$\Pi_1 = p_1(1 - \beta)V, \quad (3)$$

and that for player 2 is

$$\Pi_2 = (1 - p_1)V - (1 + \delta)x_2. \quad (4)$$

To solve for a subgame-perfect equilibrium of the two-stage game, we work backwards. In the second stage, the value of β is publicly known. Agent 1 exerts effort x_1 to maximize his expected payoff π_1 , taking agent 2's effort as given. But agent 2 exerts effort x_2 which maximizes player 2's payoff (4), not his expected payoff π_2 , taking agent 1's effort as given. That is, player 2 computes x_2 and has agent 2 implement it. Algebraically, this maximization results in each agent's reaction function. Using the two reaction functions, we then obtain a unique Nash equilibrium in the second stage of the game. We denote it by $(x_1(\beta), x_2(\beta))$.

Lemma 1. *The Nash equilibrium in the second stage of the game is*

$$x_1(\beta) = \beta^2(1 + \delta)V/\{\beta(1 + \delta) + 1\}^2 \text{ and } x_2(\beta) = \beta V/\{\beta(1 + \delta) + 1\}^2.$$

Let $p_1(\beta)$ be the probability that agent 1 wins at the Nash equilibrium of the second stage. From expression (2) and Lemma 1, we obtain

$$p_1(\beta) = \beta(1 + \delta)/\{\beta(1 + \delta) + 1\}. \quad (5)$$

Using expressions (3) and (5), we then obtain the expected payoff of player 1 at the Nash equilibrium of the second stage:

$$\Pi_1(\beta) = \beta(1 - \beta)(1 + \delta)V/\{\beta(1 + \delta) + 1\}. \quad (6)$$

Next consider the first stage in which player 1 determines the contingent-fee fraction. Player 1 chooses β to maximize her payoff (6). Let us denote the optimal value by β^* . It is then straightforward to obtain

$$\beta^* = \{(2 + \delta)^{1/2} - 1\}/(1 + \delta). \quad (7)$$

Using expressions (4), (6), (7) and Lemma 1, we obtain Lemma 2.

Lemma 2. *In the subgame-perfect equilibrium, the effort levels of agents 1 and 2 are*

$$x_1^* = \{(2 + \delta)^{1/2} - 1\}^2 V / (1 + \delta)(2 + \delta) \text{ and } x_2^* = \{(2 + \delta)^{1/2} - 1\} V / (1 + \delta)(2 + \delta).$$

The expected payoffs of players 1 and 2 are $\Pi_1^ = \{(2 + \delta)^{1/2} - 1\}^2 V / (1 + \delta)$ and $\Pi_2^* = V / (2 + \delta)$.*

4. The hourly fee for the plaintiff's lawyer and a comparison of the two fees

To reflect the typical compensation structures for European jurisdictions, we now assume hourly fees for both agents. Notice that the hourly fee is assumed for player 2, regardless of player 1's choice between the contingent and the hourly fee. This describes the fact that player 2 (the defendant in the real world) chooses the hourly fee when both the contingent and the hourly fee are feasible. This may be because she is better off under the hourly fee than under the contingent fee. Next we assume that player 1 has to pay a financing cost of rx_1 to finance her agent's hourly fee x_1 , where $r \geq 0$ is an interest rate or an insurance premium rate. Thus, $r = 0$ means that she has no credit constraint or that the two players face the same rate of the financing cost.

Let $\hat{\Pi}_i$ represent the expected payoff for player i . Then, the payoff function for player 1 is

$$\hat{\Pi}_1 = p_1 V - (1 + r + \delta)x_1, \quad (8)$$

where p_1 is defined as in expression (1), and that for player 2 is the same as in expression (4).¹⁰

Since the analysis of this game is very similar to that in Subsection 2.2, we here report only the Nash equilibrium and its outcomes of the game, omitting the derivation process.

Lemma 3. *In equilibrium, the effort levels of agents 1 and 2 are*

$$\hat{x}_1^* = (1 + \delta)V/(2 + r + 2\delta)^2 \text{ and } \hat{x}_2^* = (1 + r + \delta)V/(2 + r + 2\delta)^2,$$

and the expected payoffs of players 1 and 2 are $\hat{\Pi}_1^ = \{(1 + \delta)/(2 + r + 2\delta)\}^2V$ and $\hat{\Pi}_2^* = \{(1 + r + \delta)/(2 + r + 2\delta)\}^2V$.*

By comparing Lemma 3 with Lemma 2, we can now make a comparison between the American practice of the contingent fee and the European practice with legal expenses insurance. To do so, we have to analyze how an increase in the value of r and/or δ affects the size of Π_i^* and $\hat{\Pi}_i^*$, $i = 1, 2$.

First, consider the case where $r = 0$, i.e., the case where players 1 and 2 are symmetric. In this case, from Lemma 3, player 1's choice of the hourly fee brings $\hat{\Pi}_1^* = \hat{\Pi}_2^* = V/4$, which is independent of the value of δ . Under player 1's choice of the contingent fee, however, Π_1^* is monotonically increasing in δ and Π_2^* is monotonically decreasing in δ . This is because the increase in δ leads to the increase in player 1's cost, which puts player 2 in a better position. We find that $\Pi_1^* < \hat{\Pi}_1^*$ holds if $\delta < 0.78$, and $\Pi_2^* > \hat{\Pi}_2^*$ holds if $\delta \leq 2$.¹¹ (Throughout the paper, all decimal fractions are rounded off to two decimals.)

Next consider the case where $r > 0$. The size of $\hat{\Pi}_1^*$ is monotonically decreasing in r and that of $\hat{\Pi}_2^*$ is monotonically increasing in r , i.e., $\partial \hat{\Pi}_1^*/\partial r < 0$ and $\partial \hat{\Pi}_2^*/\partial r > 0$. This is obvious because the increase in r leads to the increase in player 1's cost. But the increase

in player 1's cost puts player 2 in a better position. Notice, however, that a change in r does not affect Π_i^* in Lemma 2. Using these facts and Lemmas 2 and 3, we then obtain Proposition 1.

Proposition 1. *Suppose that player 1 as well as player 2 does not face a credit constraint. Also suppose that $\delta < 0.78$. Then, player 1's choice of the hourly fee brings herself a more expected payoff, compared with her choice of the contingent fee. Player 2's expected payoff under player 1's choice of the hourly fee is less than that under her choice of the contingent fee. As a premium rate r of legal expenses insurance increases, however, the gap between each player's expected payoffs due to player 1's choice between the contingent and the hourly fee is getting narrower.*

An implication of Proposition 1 is that, with a moderate moral hazard cost, if player 1 could finance up-front legal costs by purchasing an insurance policy, she would be better to choose the hourly fee for her agent. Put differently, if there is no legal expenses insurance, player 1 who faces a credit constraint is obliged to choose the contingent fee in which she has no need to finance the up-front expenses. But if player 1 can purchase a legal expenses insurance policy, she may change her compensation scheme from the contingent fee to the hourly fee in order to increase her expected payoff. We can explain this, using the fact that in the real world a corporate defendant with a deep pocket sticks to the hourly fee when both the contingent and the hourly fee are available. An increase in r may affect these findings by lowering a critical value $\delta = 0.78$ slightly.

Believing that moral hazard costs regarding lawyers' effort are moderate, therefore, we may draw a policy implication: If a government's objective is to increase expected payoffs of credit-constrained plaintiffs, it may be better to introduce legal expenses insurance than contingent fees.

Proposition 1 also implies that if $\delta \geq 0.78$, player 1 prefers the contingent fee to the hourly fee. Put differently, as the degree of moral hazard increases, the contingent fee becomes more attractive to the liquidity-constrained plaintiff. Note that $\Pi_2^* > \hat{\Pi}_2^*$ holds if $\delta \leq 2$. This means that if $\delta \leq 2$, player 2 benefits from player 1's choice of the contingent fee. To make our model more convincing and realistic, however, we restrict our attention to the case $\delta < 0.78$.

It is of great interest to compare the equilibrium total expenditure levels under player 1's choice of the contingent fee with those under her choice of the hourly fee. Let p_1^* denote player 1's winning probability in equilibrium under the contingent fee. Then, using (3), (4), and Lemma 2, we obtain the equilibrium total expenditure level under the contingent fee: $p_1^* \beta^* V + (1 + \delta)x_2^* = \{2(2 + \delta)^{3/2} - 3(1 + \delta) - 2\}V / \{(1 + \delta)(2 + \delta)\}$. It increases monotonically as δ goes up to 2.61; it reaches its maximum, $0.42V$, when $\delta = 2.61$; and then it decreases monotonically. Similarly, using (4), (8), and Lemma 3, we obtain the equilibrium total expenditure levels under the hourly fee: $(1 + r + \delta)\hat{x}_1^* + (1 + \delta)\hat{x}_2^* = 2(1 + \delta)(1 + r + \delta)V / (2 + r + 2\delta)^2$, which is monotonically increasing in δ and decreasing in r . When $r = 0$, it reaches its maximum, $0.5V$, which is independent of δ . Comparing the two total expenditure levels, we then obtain Proposition 2.

Proposition 2. *Suppose that player 1 as well as player 2 does not face a credit constraint. Then, the equilibrium total expenditure levels under the contingent fee is less than those under the hourly fee. As r increases, however, the gap between the two levels is getting narrower.*

Note that, unlike Proposition 1, Proposition 2 holds regardless of the value of δ . Proposition 2 implies that player 1's adoption of the contingent fee incurs less legal expenditures of litigants than her adoption of the hourly fee with legal expenses insurance.

The intuition behind this result is due to the delegation argument: A principal can benefit by using a delegate whose objective function differs from hers. Player 1's adoption of the contingent fee makes her agent's objective function differ not only from herself but also from agent 2's objective function, which makes competing agents less aggressive. But the implication of Proposition 2 holds under the condition that the contingent fee does not bring more lawsuits than the hourly fee.¹²

5. Concluding remarks

We have modeled a lawsuit as a contest with delegation when a credit constraint may be binding for a plaintiff, but not for a defendant. We first have considered the model in which agent 1 (the plaintiff's lawyer) works on a contingent-fee basis but agent 2 (the defendant's lawyer) works on an hourly-fee basis. Next we have considered the modified model in which agent 1 as well as agent 2 works on the hourly-fee basis. Then we have compared the two models.

Using the comparison, under the condition that moral hazard costs regarding lawyers' effort are not too great, we have shown that if a government wants to increase expected payoffs of credit-constrained plaintiffs, it may be better to introduce legal expenses insurance than to allow the practice of contingent fees. But if the government's objective is to reduce the level of litigants' legal expenditures, allowing contingent fees may be better than the introduction of legal expenses insurance. This trade-off between the introduction of contingent fees and that of legal expenses insurance shed light on the Korean and Japanese jurisdictions that are now contemplating the introduction of an institution to help credit-constrained plaintiffs: It depends on their objectives which institution will serve them better between the contingent fees and legal expenses insurance.

In the real world, a plaintiff is often a credit constrained individual who also had no experience in litigation before. But a defendant is usually a firm that has a deep pocket and a lot of experience in litigation. This may bring a couple of asymmetry between the

plaintiff and defendant. First, the defendant could hire an abler lawyer than the plaintiff. Second, the defendant usually incurs less monitoring costs than the plaintiff. This is because the corporate defendant as a repeat player can easily acquire the "know-how" of keeping a lawyer under the hourly fee, compared with the individual plaintiff as an one-time player. Thus, two extensions of our model seem important: (i) considering the case in which agents are differentiated by their ability and player 2 has better access to abler agents than player 1; (ii) assuming that player 2's monitoring technology is superior to that of player 1. We leave these extensions for future research.

Footnotes

1. Though illegal, lawyers in Korea and Japan are increasingly using contingent fees, resorting to an expedient of contract law. Recently, Korean courts have begun to recognize the appropriateness of contingent fees in certain types of cases. Contrary to a popular belief, Kritzer (2002) reports that contingent fees are not a uniquely American phenomenon. He finds that contingent fees have been permitted, though very limitedly, in some countries such as Australia, Canada, France, Ireland, Japan, New Zealand and Scotland.

2. A few researchers have adopted contest models to analyze lawsuits. Examples are Katz (1988), Farmer and Pecorino (1999), Wärneryd (2000), and Hirshleifer and Osborne (2001). But unlike these papers, our model has two more players – a plaintiff's lawyer and a defendant's lawyer – to whom the plaintiff and defendant delegate a lawsuit contest

3. In the United States, most of plaintiffs in tort litigation hire their lawyers under contingent fees, while defendants' lawyers are usually paid under hourly fees (see Dana and Spier, 1993; Bebchuk and Guzman, 1996).

4. There are some reasons why we model a lawsuit as a contest with logit-form probability-of-winning functions. First of all, an award or recovery of the case corresponds to a prize in a contest. Namely, a plaintiff seeks the award, while a defendant tries to defend it. Second, to obtain the award both parties bear their own legal costs even if one of them loses the case. Similarly, players in a contest expend irreversible effort to win the prize, but only one of them wins. Third, a party with higher effort is not guaranteed victory, but rather has a greater likelihood of victory. The logit-form litigation success functions are appropriate for the description of such a likelihood.

5. Besides the hourly fee with legal expenses insurance, there is another type of fee arrangement in the United Kingdom: a conditional fee under which a lawyer gets an upscale premium if he wins, however, unrelated to the amount at stake. Emons and Garoupa (2004) compare conditional and contingent fees in a principal-agent framework where a lawyer expends unobservable effort after he has observed the amount at stake.
6. The idea that strategic delegation benefits a principal has long been emphasized in many contexts: Schelling (1960), Fershtman and Judd (1987), Baik and Kim (1997), Fershtman and Kalai (1997), and Wärneryd (2000) to name a few.
7. Player 1 tries to win V while player 2 wants to defend V . Hence, winning the lawsuit is worth V for both players.
8. Fershtman and Kalai (1997) distinguish between two types of delegation: incentive and instructive delegation. According to their classification, in our model, player 1 is adopting incentive delegation while player 2 instructive delegation.
9. If δ denotes a possible overcharge rate instead of the monitoring cost rate, π_2 equals δx_2 .
10. In this paper, we employ the American fee-shifting rule, under which the plaintiff and defendant pay their own litigation costs, instead of the British rule, under which the loser reimburses the winner's litigation costs including the lawyer's fees (Baye, Kovenock and de Vries, 2005). Posner (1998, p. 633) mentions that even under the American rule the loser has to reimburse the winner for court fees, copying costs and some witness fees, but excluding the lawyer's fees. In Korea and Japan, the reimbursement amount of the

lawyer's fees approved by courts is very small, compared with that of US and UK. Thus, we may say that the fee-shifting rule of Korea and Japan is close to the American rule.

11. The degree of moral hazard could take a form of overcharge rate. Interestingly, Kritzer (1990, pp. 135-61) reports that, on average, hourly-fee lawyers spent 49.5 hours and contingent-fee lawyers 45.7 hours in civil litigation in the United States. If we interpret the difference in hours spent as the overcharge, $\delta = (49.5 - 45.7)/45.7 = 0.08$, which is much less than 0.78.

12. Miceli (1994) argues that it is ambiguous whether or not the contingent fee leads to more suits than the hourly fee. In their empirical study on medical malpractice cases, Helland and Tabarrok (2003) find that it is not the contingent fee but the hourly fee to encourage the filing of low-quality, "frivolous" litigation.

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