PLEASE DO NOT QUOTE OR CIRCULATE
VERY PRELIMINARY VERSION
The Economics of Reverse Contingent Fees*

Albert CHOI†
University of Virginia

Nuno GAROUPA‡
Universidade Nova de Lisboa
CEPR, London

June 2005

Abstract

We provide a strategic explanation for the fact that defendants do not use reverse contingent fees.

Keywords: contingent fees, reverse contingent fees, incentives
JEL: D82, K1

*We thank xxx for helpful comments. The usual disclaimers apply.

†Associate Professor of Law, School of Law, University of Virginia, 580 Massie Road, Charlottesville, VA 22903-1789. Phone: (434)924-4709. Fax: (434)924-7536. Email: ahc4p@virginia.edu

‡Professor of Law and Economics, Faculdade de Economia, Universidade Nova de Lisboa, Campus de Campolide, P-1099-032 Lisboa, Portugal. Phone: 351-21-3801600. Fax: 351-21-3870933. Email: ngaroupa@fe.unl.pt

1 Introduction

It is well-documented that defendants do not use contingent fees in litigation (Kritzer, 1990). However, this point has not deserved any particular attention in the literature. By now, there is a vast literature on contingent fees (for the plaintiffs lawyer).

One first explanation relates contingent fees to cases when the plaintiff is liquidity constrained and capital markets are imperfect. This observation relies on the fact that many plaintiffs do not have enough assets to hire an attorney under a regime of hourly or flat fees, a problem also emphasized by those who oppose the substitution of legal aid by conditional fees in Europe (White, 1978; Yarrow, 2001). A similar argument could be easily applied to defendants since they may not have enough assets to pay damages and remunerate the lawyer. Reverse contingent fees mitigate the problem by reducing the remuneration of lawyer when damages have to be paid (since the case has been lost for the defendant).

A second explanation sees contingent fees as a risk-sharing device. The lawyer is presumably less risk averse than the client due to the fact that it is easier for her to diversify the risks from lawsuits. Thus, contingent legal fees would share the risk more efficiently than hourly or flat fees because they shift some of the risk from the more risk averse client to the less risk averse lawyer. It is true a high proportion of defendants are corporate clients (hence the risk-sharing argument might be less appealing), but then the issue has to do with the corporate nature of the defendant (Garoupa and Gomez, 2004).

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). These explanations rely on multiple-plaintiffs sharing the same lawyer, but could be easily developed in the context of multiple-defendants sharing the same lawyer. It is true that the latter is less frequent than the

former, but the argument is still valid even if for a small number of cases.

Final, the other explanations for contingent fees are all based on asymmetric information between the lawyer and her 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 or flat fees which tend to induce shirking (Schwartz and Mitchell, 1970; Mitchell and Schwartz, 1972; Danzon, 1983; Halpern and Turnbull, 1983; Miceli and Segerson, 1991; Dana and Spier, 1993; Gravelle and Waterson, 1993; Rubinfeld and Scotchmer, 1993; Rickman, 1994; Hay, 1996; Emons, 2000; Polinsky and Rubinfeld, 2003; Emons and Garoupa, 2005). The moral hazard problem is not just on the plaintiffs side, but also on the defendants. Hence, a need for contingent fees as performance-oriented remuneration would also make sense.

In our view, previous literature has not provided any obvious rationale for the observation that defendants do not use contingent fees. The goal of the paper is to fill such gap. A simple model is sketched in the next section. Several considerations concerning possible extensions are discussed at the end of the paper.

2 Model

Suppose there is a dispute between a plaintiff P and a defendant D over an award to be adjudicated. The sequence of events is the following:

(1) Plaintiff P hires a lawyer PA under a specific regime of legal fees and a lawsuit is filed;

(2) Defendant D hires a lawyer DA under a specific regime of legal fees;

(3) Plaintiff P decides whether or not to drop the lawsuit;

(4) If the lawsuit is not dropped, PA and DA make a decision concerning which strategy to be pursued in litigation;

(5) The payoffs are revealed.

The plaintiff can hire a lawyer for a flat fee w or a contingent fee α, the defendant can hire a lawyer for a flat fee y or a reversed contingent fee β. The reservation utility of both lawyers is v.

Each lawyer has to make a decision concerning which strategy to be pursued in litigation. Consider the case where there are two strategies, safe and risky litigation. There are three possibilities to be considered:

(i) Both lawyers choose Safe: plaintiff wins J with probability one.

(ii) One lawyer chooses Risky: plaintiff wins $J + a$ with probability $1/2$ and $J - a$ with probability $1/2$, with $a \in [0, J/2]$.

(iii) Both lawyers choose Risky: plaintiff wins $J + 2a$ with probability $1/2$ and $J - 2a$ with probability $1/2$.

Everyone is equally risk averse to make sure our argument does not rely on a particular distribution of risk preferences. Everyone has a utility function $U(.)$, satisfying the usual assumptions, $U'(.) > 0$ and $U''(.) < 0$. For purposes of exposition, without loss of generality, we assume that $U(.)$ is a Von Neumann-Morganstern utility function given by the expected value minus the variance of the lottery.

We solve the game backwards for subgame perfection. Let us start by looking at the choice of strategy by lawyers. The decision by each lawyer depends on which regime of legal fees they operate. There are four possibilities to be considered:

(i) **Both lawyers are under flat fees**: When both lawyers operate under flat fees, the payoffs are w and y for the lawyer hired by plaintiff and

defendant respectively. Therefore, they are indifferent between safe or risky litigation strategies. For sake of simplicity, let us assume that if they are indifferent, they pick risky.[1]

Since both lawyers will be playing it risky, we have the following expected utilities for plaintiff and defendant:

$$\begin{aligned} EU_P &= J - 4a^2 - w \\ EU_D &= -(J + 4a^2 + y) \end{aligned} \tag{1}$$

By solving the participation constraint, we know that $w = y = v$, hence the expected payoffs for plaintiff and defendant when both lawyers are hired under flat fees are:

$$\begin{aligned} EU_P &= J - 4a^2 - v \\ EU_D &= -(J + 4a^2 + v) \end{aligned} \tag{2}$$

(ii) **One lawyer, DA, is under flat fees, and the other, PA, is under contingent fees**: Since the defendants side is on flat fees, risky litigation is chosen, and the expected payoff for the lawyer hired by plaintiff under contingent fees is

$$\alpha J - \alpha^2 a^2$$

if safe litigation and

$$\alpha J - 4\alpha^2 a^2$$

if risky litigation. Therefore, the lawyer will choose a safe litigation strategy under contingent fees.

Since one lawyer will be playing it risky (defendant) and the other will be playing it safe (plaintiff), we have the following expected utilities for plaintiff

[1] In general, we would expect them to randomize. This would make the analytics more cumbersome, but without any further gain in insight.

and defendant:

$$\begin{aligned} EU_P &= (1-\alpha)J - (1-\alpha)^2 a^2 \\ EU_D &= -(J + a^2 + y) \end{aligned} \tag{3}$$

By solving the participation constraint, we know that $y = v$ and α must satisfy

$$\alpha J - \alpha^2 a^2 = v,$$

hence the expected payoffs for plaintiff and defendant respectively are:

$$\begin{aligned} EU_P &= J - [\alpha^2 + (1-\alpha)^2] a^2 - v \\ EU_D &= -(J + a^2 + v) \end{aligned} \tag{4}$$

(iii) **Both lawyers are under contingent fees**: Under reverse contingent fees, the expected payoff for the lawyer hired by the defendant is

$$y - \beta J$$

if safe litigation and

$$y - \beta J - \beta^2 a^2$$

if risky litigation. Therefore, the lawyer will choose a safe litigation strategy under reverse contingent fees.

Since both lawyers will be playing it safe (given that the plaintiffs lawyer is under contingent fees), we have the following expected utilities:

$$\begin{aligned} EU_P &= (1-\alpha)J \\ EU_D &= -[(1-\beta)J + y] \end{aligned} \tag{5}$$

By solving the participation constraint, we know that $y - \beta J = v$ and $\alpha J = v$, hence the expected payoffs are:

$$\begin{aligned} EU_P &= J - v \\ EU_D &= -(J + v) \end{aligned} \tag{6}$$

Table 1: Expected payoffs of plaintiff and defendant

Fees	Plaintiff	Defendant
Flat, Flat	$J - 4a^2v$	$-(J + 4a^2 + v)$
Flat, CF	$J - [\alpha^2 + (1-\alpha)^2]a^2 - v$	$-(J + a^2 + v)$
RCF, Flat	$J - a^2 - v$	$-(J + (1-\beta)^2a^2 + \beta^2a^2 + v)$
RCF, CF	$J - v$	$-(J + v)$

(iv) **One lawyer, PA, is under flat fees, and the other, DA, is under reverse contingent fees**: Consider now the situation where the defendant chooses reverse contingent fees, but the plaintiff goes for flat fees. Since one lawyer will be playing it risky (plaintiff) and the other will be playing it safe (defendant), we have the following expected utilities:

$$\begin{aligned} EU_P &= J - a^2 - w \\ EU_D &= -((1-\beta)J + (1-\beta)^2a^2 + y) \end{aligned} \tag{7}$$

By solving the participation constraint, we know that $y - \beta J - \beta^2 a^2 = v$ and $w = v$, hence the expected payoffs for plaintiff and defendant respectively are:

$$\begin{aligned} EU_P &= J - a^2 - v \\ EU_D &= -(J + (1-\beta)^2a^2 + \beta^2a^2 + v) \end{aligned} \tag{8}$$

We can summarize the results in the following table:

Having solved the choice of litigation strategy by lawyers, PA and DA, we turn now to decision by the plaintiff to whether or not drop the lawsuit altogether. The plaintiff will drop the lawsuit if the expected payoff is negative (since the reservation utility for the plaintiff has been normalized to zero). We can present the following results:

(i) **Both lawyers are under flat fees**: Plaintiff drops a lawsuit if $J \in [0, 4a^2 + v]$.

(ii) **One lawyer, DA, is under flat fees, and the other, PA, is under contingent fees**: Plaintiff drops a lawsuit if $J \in [0, (\alpha^2 + (1-\alpha)^2)a^2 + v]$.

(iii) **Both lawyers are under contingent fees**: Plaintiff drops a lawsuit if $J \in [0, v]$.

(iv) **One lawyer, PA, is under flat fees, and the other, DA, is under reverse contingent fees**: Plaintiff drops a lawsuit if $J \in [0, a^2 + v]$.

Therefore we can rank the scenarios with respect to the likelihood of plaintiff dropping a lawsuit. It is more likely in (i), followed by (iv), (ii), and finally (iii).

We move now to the decision by the defendant of hiring a lawyer. Suppose when making the decision concerning hiring a lawyer, J is not known, but the defendant has information about the probability density function $g(j)$. Consider the case under which the plaintiff has opted for flat fees. Then the expected payoffs for the defendant for flat fee and reverse contingent fees are respectively:

$$\begin{aligned} EU_{DFF} &= -\int_{v+4a^2]}^{\infty} (J + 4a^2 + v) dG(J) \\ EU_{DRCF} &= -\int_{v+a^2}^{\infty} (J + (1-\beta)^2 a^2 + \beta^2 a^2 + v) dG(J) \end{aligned}$$

The defendant will choose flat fees as long as $EU_{DFF} < EU_{DRCF}$ which is not universally satisfied. There is a trade-off between bearing a lower cost (under reverse contingent fees) and a lawsuit being dropped (under flat fees).

Consider now the case under which the plaintiff has opted for contingent fees. Then the expected payoffs for the defendant for flat fee and reverse contingent fees are respectively:

$$\begin{aligned} EU_{DFF} &= -\int_{v+(\alpha^2+(1-\alpha)^2)a^2]}^{\infty} (J + a^2 + v) dG(J) \\ EU_{DRCF} &= -\int_{v}^{\infty} (J + v) dG(J) \end{aligned}$$

As before, the defendant will choose flat fees as long as $EU_{DFF} < EU_{DRCF}$ which is not universally satisfied. Finally, we turn to the decision by the plaintiff. It is clear that the plaintiff always prefers to hire a lawyer under contingent fees because it shifts risk to the lawyer.

Hence we can summarize the following results:
(1) The plaintiff always chooses contingent fees because it shifts risk;
(2) If the defendant hires a lawyer under flat fees, claims such that $J \in [0, (\alpha^2 + (1-\alpha)^2)a^2 + v]$ will not be filed.
(3) If the defendant hires a lawyer under reverse contingent fees, claims such that $J \in [0, v]$ will not be filed.
(4) Clearly there is a trade-off between the likelihood of a claim (lower for flat fees) and risk (lower for reverse contingent fees). For the same likelihood of claim, reverse contingent fees are preferred. However, defendants may want to reduce the likelihood of claim, accepting more risk if a claim is filed. Hence, the choice of flat fees.

3 Further Rationales to be Considered

We hope to be able to include or discuss the following aspects in a next draft:
(1) An extended version of the current model: the defendant making a trade-off between hourly or flat-fee associated moral hazard problem and reverse-contingent-fee associated strategy choice problem, which, in the end, can produce an equilibrium where the defendant chooses the hourly fees but become very willing to settle, which, in turn, creates an incentive for the plaintiff to file frivolous lawsuits for the sake of settling.
(2) A high proportion of cases in the US are of multiple defendants with multiple lawyers. If we usually have co-defendants, using contingent fees would allow the defendant who does not use them to free-ride on the one who uses it (contingent fees solve moral hazard, more effort by lawyer, high marginal probability of winning for both defendants even if they do not use

the same lawyer, but only one defendant really pays for it). Therefore, both co-defendants choose hourly or flat fees to avoid free-riding or in the hope of free riding on the other.
(3) Concerning the possibility of renegotiation once it is clear that the plaintiff is not dropping, it could be that for defendants, a higher proportion of the effort to win has to be exerted at the beginning rather than at the end of the lawsuit. Hence, when it clear that the plaintiff is not dropping the lawsuit and we are going ahead, it could be that the moral hazard problem for the defendant is not too important as it is for the plaintiff. Hence the defendant keeps flat or hourly fees because there is some renegotiation cost (which in a sense in the current draft we assume it is very high) and no obvious benefits.

References

References

Dana, J. and K. Spier. Expertise and Contingent Fees: the Role of Asymmetric Information in Attorney Compensation, *Journal of Law, Economics and Organization* 9 (1993): 349-367.

Danzon, P. Contingent Fees for Personal Injury Litigation, *Bell Journal of Economics* 14 (1983): 213-224.

Emons, W. Expertise, Contingent Fees, and Insufficient Attorney Effort, *International Review of Law and Economics* 20 (2000): 21-33.

Emons, W. and N. Garoupa, N. The Economics of US-style Contingent Fees and UK-style Conditional Fees, University of Bern mimeograph (2005).

Garoupa, N. and F. Gomez. Cashing by the Hour: Why Large Law Firms Prefer Hourly Fees Over Contingent Fees, Universitat Pompeu Fabra mimeograph (2004).

Gravelle, H. and M. Waterson. No Win, No Fee: Some Economics of Contingent Legal Fees, *Economic Journal* 420 (1993): 1205-1220.

Halpern, P. J. and S. M. Turnbull. Legal Fees Contracts and Alternative Cost Rules: An Economic Analysis, *International Review of Law and Economics* 3 (1983): 3-26.

Hay, B. Contingent Fees and Agency Costs, *Journal of Legal Studies* 25 (1996): 503-533.

Klement, A. and Z. Neeman. Incentive Structures for Class Action Lawyers, *Journal of Law, Economics, and Organization* (2004), 125-147.

Kirstein, R. and N. Rickman. Third Party Contingency Contracts in Settlements and Litigation, *Journal of Institutional and Theoretical Economics* (2004): Forthcoming.

Kritzer, H. The Justice Broker: Lawyers and Ordinary Litigation (1990). Oxford: Oxford University Press.

Lynk, W. J. The Courts and the Market: An Economic Analysis of Contingent Fees in Class-Action Litigation, *Journal of Legal Studies* 19 (1990): 247-260.

Miceli, T. J. and K. Segerson. Contingent Fees for Lawyers: The Impact on Litigation and Accident Prevention, *Journal of Legal Studies* 20 (1991): 381-399.

Mitchell, D. J. and M. L. Schwartz. Theoretical Implications of Contingent Legal Fees, *Quarterly Review of Economics and Business* 12(1972): 69-76.
Polinsky, A. M. and D. Rubinfeld. Aligning the Interests of Lawyers and Clients, *American Law and Economics Review* 5 (2003): 165-188.
Rickman, N. The Economics of Contingency Fees in Personal Injury Litigation, *Oxford Review of Economic Policy* 10(1994): 34-50.
Rubinfeld, D. and S. Scotchmer. Contingent Fees for Attorneys: An Economic Analysis, *Rand Journal of Economics* 24 (1993): 343-356.
Santore, R. and A. D. Viard. Legal Fee Restrictions, Moral Hazard, and Attorney Rents, *Journal of Law and Economics* 44 (2001): 549-572.
Schwartz, M. L. and D. J. Mitchell. An Economic Analysis of the Contingent Fee in Personal Injury Litigation, *Stanford Law Review* 22 (1970): 1125-1162.
White, R. C. Contingent Fees: A Supplement of Legal Aid?, *Modern Law Review* 41 (1978): 286-298.
Yarrow, S. Conditional Fees, *Hume Papers on Public Policy* 8 (2001): 1-10.