Contingent Fees versus Legal Expenses Insurance

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Abstract

We model a civil dispute as a contest with delegation. 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. Next, we study 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 an hourly-fee basis. Comparing the American and the European practice, we show: (i) the plaintiff may prefer the European one to the American one; (ii) the European one may incur more legal expenses than the American one. These findings shed light on the Japanese and Korean jurisdictions that have to introduce an institution to support credit-constrained plaintiffs.

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

JEL classification: K41; K13; D74; D72

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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 litigant, 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 she loses. On the other hand, the majority of European jurisdictions have well-developed insurance markets for legal expenses (see van Velthoven and van Wijck, 2001; Heyes, Rickman and Tzavara, 2004).

In some countries such as Japan and Korea, however, officially neither contingent fees nor legal expenses insurance exists. 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 these countries' jurisdictions better, contingent fees or legal expenses insurance? To answer this question, we develop a contest model with delegation in which a plaintiff's lawyer works either on a contingent-fee basis or on an hourly-fee basis, but a defendant's lawyer works on an hourly-fee basis. We assume that a credit constraint may be binding for a plaintiff (usually an individual), but not for a defendant (usually a firm).

We first consider a model in which the plaintiff adopts the contingent fee for her lawyer (the American practice of contingent fees). The contingent fee frees the plaintiff from the possible credit constraint. To be more precise, our two-stage game runs as follows. In the first stage, knowing that the defendant adopts 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. We
use a logit-form litigation success function in which the probability of prevailing for a party
depends solely on the two competing lawyers' effort levels.4

Next, we consider a modified model in which the plaintiff as well as the defendant adopts
the hourly fee and she 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 the cost of buying the insurance and the moral hazard
cost regarding lawyers' effort are not too large, the European practice brings the plaintiff more
expected payoffs, compared to the American one. 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 fee are available. Thus, if a government's objective is to help credit-
constrained plaintiffs maximize their expected payoffs, it may be better to introduce the
European practice than the American one.

We next show that the American practice incurs less legal expenditures than the
European one. 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 client's but also
from that of the defendant's lawyer, which makes competing lawyers less aggressive. This draws
a policy implication for the government that has to introduce contingent fees or legal expenses
insurance. If the government wants to lower the level of litigation costs (or, equivalently, to
increase the sum of the plaintiff's and the defendant's expected payoffs), then the introduction of
the American practice may be a better choice 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. Thus, we are able to say that it depends on the Japanese
and Korean jurisdictions’ objectives which institution will serve them better – the American or the European practice.

Before proceeding, 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. To be specific, 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 (2006). Contingent fees and legal expenses insurance may also be viewed as a mechanism for a risk-averse plaintiff to shift the risk of incurring legal expenses. See, e.g., Posner (1998, pp. 624-632) for contingent fees, and Heyes, 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, assuming that the plaintiff, defendant, 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 Section 2, we set up the basic model. Section 3 considers a 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 an hourly-fee basis, and the plaintiff may have to purchase a legal expenses insurance policy. Section 5 compares the outcomes from the two models. Section 6 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 litigant hires a lawyer for the lawsuit. For concise exposition, let us call the plaintiff player 1 and her lawyer agent 1, and call the defendant player 2 and her lawyer agent 2. We model the situation as a contest: Agents 1 and 2 who represent
players 1 and 2, respectively, expend their effort simultaneously and independently to win the 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 value the prize at $V$.

Let $x_1$ and $x_2$ be the agents' effort levels in units commensurate with the prize, and let $p_1$ be the probability that agent 1 prevails. As in some litigation contest models (e.g., Katz, 1988; Baik and Kim, 1997), we assume that the litigation success function for agent 1 is:

$$p_1 = \frac{x_1}{x_1 + x_2} \quad \text{for} \quad x_1 + x_2 > 0$$

$$1/2 \quad \text{for} \quad x_1 + x_2 = 0.$$  

This function implies that the winning probability depends solely on the agents' effort. It also implies that players 1 and 2 have the same degree of fault: The probability of winning for player 1 when agent 1 expends $a$ and agent 2 expends $b$ is equal to that for player 2 when agent 1 expends $b$ and agent 2 expends $a$.

The players and agents are risk-neutral. Their objectives are to maximize their own expected payoffs. Player 1 chooses between two possible fee contracts for agent 1: (i) under a contingent fee contract, an agent receives the fee that is proportional to $V$ if he prevails, and nothing if he does not; (ii) under an hourly fee contract, the agent's fee is based on his effort level, regardless of the outcome of the contest. If player 1 faces a credit constraint, she has to purchase a legal expenses insurance policy in order to use the hourly fee. But player 2 who has no credit constraint always adopts the hourly fee for agent 2, regardless of player 1's choice.

3. The contingent fee for the plaintiff's lawyer

To reflect the typical compensation structure 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 $\beta V$, where $0 < \beta < 1$. Since it is paid only if agent 1 prevails, 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 $\delta x_2$, 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 $(1 + \delta)x_2$. There might be another way to describe it: The parameter $\delta$ could be used to denote a possible overcharge rate instead of the monitoring cost rate. Exploiting his information advantage on $x_2$, for instance, agent 2 could overcharge his fee by an amount of $\delta x_2$. We assume that $\delta$ is exogenously given and publicly known.

We formally consider the following two-stage game. In the first stage, knowing that player 2 adopts the hourly fee, player 1 determines the contingent-fee fraction $\beta$ for agent 1 and announces it publicly. In the second stage, agent 1 and player 2 choose the effort levels, $x_1$ and $x_2$, simultaneously and independently which agents 1 and 2 will expend, respectively. After the agents expend $x_1$ and $x_2$, the winner is determined, and the players pay compensation to their agents according to their contracts.

Let $\pi_i$ represent the expected payoff for agent $i$. Then the payoff function for agent 1 is

$$\pi_1 = p_1 \beta V - x_1.$$  \hspace{1cm} (2)

Agent 2 who puts $x_2$ receives the hourly fee $x_2$ from player 2. Thus, the payoff function for agent 2 is $\pi_2 = x_2 - x_2 = 0$. In this paper, we employ the American fee-shifting rule under which each player bears her own costs, regardless of the outcome of the contest. The payoff function for player 1 is

$$\Pi_1 = p_1 (1 - \beta) V,$$  \hspace{1cm} (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 \( \beta \) is publicly known. Agent 1 exerts effort \( x_1 \) to maximize his expected payoff \( \pi_1 \), taking agent 2's effort as given. But agent 2 exerts effort \( x_2 \) which maximizes player 2's payoff (4), 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
\[
    x_1(\beta) = \beta^2(1 + \delta)V/\{\beta(1 + \delta) + 1\}^2 \quad \text{and} \quad x_2(\beta) = \beta V/\{\beta(1 + \delta) + 1\}^2.
\]

Let \( p_1(\beta) \) be the probability that agent 1 wins at the Nash equilibrium of the second stage. From expression (1) 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 for 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 \( \beta \) to maximize her payoff (6). Let us denote the optimal value by \( \beta^* \). It is straightforward to obtain
\[
    \beta^* = \{(2 + \delta)^{1/2} - 1\}/(1 + \delta). \quad (7)
\]

Using expressions (4) through (7) and Lemma 1, we obtain Lemma 2.
Lemma 2. In the subgame-perfect equilibrium, the effort levels of agents 1 and 2 are
\[ x_1^* = \{2 + \delta\}^{1/2} - 1 \}^2 V / \{1 + \delta)(2 + \delta)\} \text{ and } x_2^* = \{2 + \delta\}^{1/2} - 1 \}^2 V / \{1 + \delta)(2 + \delta)\}. \]
The probability of winning for agent 1 is \( p_1^* = \{(2 + \delta)^{1/2} - 1 \}/(2 + \delta)^{1/2}. \)
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

To reflect the typical compensation structure for European jurisdictions, we now assume hourly fees for both agents. To depict legal expenses insurance, we also assume that player 1 has to pay a financing cost of \( rx_1 \) to finance her agent's hourly fee \( x_1 \), where \( r \geq 0 \). The rate \( r \) is the difference between player 1's financing and player 2's opportunity cost. Thus, \( r = 0 \) means that player 1 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 \( i \) when player 1 adopts the hourly fee for agent 1. Then, the payoff function for player 1 is
\[ \hat{\Pi}_1 = p_1 V - (1 + r + \delta) x_1, \]
where \( p_1 \) is defined as in expression (1). The payoff function for player 2 is the same as in expression (4).

Since the analysis of this game is very similar to the analysis in Section 3, we here report only the results, omitting the derivations.

Lemma 3. In equilibrium, the effort levels of agents 1 and 2 are \( \hat{x}_1^* = (1 + \delta) V / (2 + r + 2\delta)^2 \)
and \( \hat{x}_2^* = (1 + r + \delta) V / (2 + r + 2\delta)^2 \); and the expected payoffs of players 1 and 2 are \( \hat{\Pi}_1^* = \{(1 + \delta)/(2 + r + 2\delta)\}_2 V \) and \( \hat{\Pi}_2^* = \{(1 + r + \delta)/(2 + r + 2\delta)\}_2 V \).
5. A comparison of the two models

Using Lemmas 2 and 3, we can make a comparison between the American practice of the contingent fee and the European practice with legal expenses insurance. To do so, we begin by analyzing how an increase in \( r \) and/or an increase in \( \delta \) affect the sizes of \( \Pi^*_i \) and \( \hat{\Pi}^*_i \), for \( i = 1, 2 \). First, consider the case where \( r = 0 \) — that is, the case where players 1 and 2 are symmetric. This case is illustrated in Figure 1. The figure shows both the players' equilibrium expected payoffs under player 1's choice of the hourly fee, \( \hat{\Pi}^*_1 \) and \( \hat{\Pi}^*_2 \), and those under her choice of the contingent fee, \( \Pi^*_1 \) and \( \Pi^*_2 \). The expected payoffs \( \hat{\Pi}^*_1 \) and \( \hat{\Pi}^*_2 \) are equal to \( V/4 \) (see Lemma 3), and thus remain unchanged as \( \delta \) increases. The expected payoff \( \Pi^*_1 \) is initially less than \( \hat{\Pi}^*_1 \), and it is monotonically increasing in \( \delta \). This is because an increase in \( \delta \) lowers the contingent-fee fraction \( \beta^* \) in (7), but heightens \( p^*_1 \) in Lemma 2. On the other hand, \( \Pi^*_2 \) is initially greater than \( \hat{\Pi}^*_2 \), and is monotonically decreasing in \( \delta \). We find that \( \Pi^*_1 < \hat{\Pi}^*_1 \) holds if \( \delta < 0.78 \), and \( \Pi^*_2 > \hat{\Pi}^*_2 \) holds if \( \delta \leq 2.15 \). (Throughout the paper, all decimal fractions are rounded off to two decimals.)

Next consider the case where \( r > 0 \). A change in \( r \) does not affect \( \Pi^*_i \) (see Lemma 2). But \( \hat{\Pi}^*_1 \) is monotonically decreasing in \( r \), and \( \hat{\Pi}^*_2 \) is monotonically increasing in \( r \). In terms of symbols, \( \partial \hat{\Pi}^*_1 / \partial r < 0 \) and \( \partial \hat{\Pi}^*_2 / \partial r > 0 \). This is obvious because an increase in \( r \) leads to an increase in player 1’s cost under her choice of the hourly fee. That is, the more expensive the financing cost, the less profitable the hourly-fee compensation scheme to player 1. But the increase in player 1’s cost puts player 2 in a better position. Thus, an increase in \( r \) lowers the critical value that makes \( \Pi^*_i = \hat{\Pi}^*_i \), for \( i = 1, 2 \). Let \( \bar{\delta}_i \) denote the critical value for player \( i \). Then, we have \( \partial \bar{\delta}_i / \partial r < 0 \). For instance, if \( r = 0 \), then the critical values are \( \bar{\delta}_1 = 0.78 \) (see Figure 1) and \( \bar{\delta}_2 = 2 \); if \( r = 0.1 \), then we have \( \bar{\delta}_1 = 0.61 \) and \( \bar{\delta}_2 = 1.87 \); if \( r = 0.2 \), then we have \( \bar{\delta}_1 = 0.43 \) and \( \bar{\delta}_2 = 1.73 \). Believing that the value of \( r \) in a real-life situation is moderate, we obtain Proposition 1 (see Lemmas 2 and 3, and footnote 15).

**Proposition 1.** Suppose that the moral hazard cost and the financing cost are not too large. 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 player 1's choice of the contingent fee.

Proposition 1 says that, with a moderate moral hazard cost, if player 1 could finance up-front legal expenses at "reasonable" costs, she would be better off choosing the hourly fee for her agent than the contingent fee. Put differently, if there is no legal expenses insurance, player 1 who faces a credit constraint is obliged to choose the contingent fee. But if player 1 could purchase a legal expenses insurance policy at a moderate premium rate, she would change her compensation scheme from the contingent fee to the hourly fee in order to increase her expected payoff (see footnote 9). Therefore, we may draw a policy implication from Proposition 1: If a government's objective is to help credit-constrained plaintiffs maximize their expected payoffs, it may be better to introduce the European practice than the American one.

It is of great interest to compare the equilibrium total "effort level" of the players under player 1's contingent fee with that under her hourly fee. Using (7) and Lemma 2, we obtain the players' total effort level under the contingent fee: 

\[ p_1^* \beta^* V + (1 + \delta)x_2^* = \frac{\{2(2 + \delta)^{3/2} - 3(1 + \delta) - 2\} V}{(1 + \delta)(2 + \delta)}, \]

which is independent of \( r \). Initially, it is monotonically increasing in \( \delta \); it reaches its maximum, 0.42\( V \), when \( \delta = 2.61 \); then it is monotonically decreasing in \( \delta \). Similarly, using Lemma 3, we obtain the players' total effort level under the hourly fee: 

\[ (1 + r + \delta)x_1^* + (1 + \delta)x_2^* = \frac{2(1 + \delta)(1 + r + \delta) V(2 + r + 2\delta)^2}{(1 + \delta)(2 + \delta)}, \]

which is monotonically increasing in \( \delta \) and monotonically decreasing in \( r \). When \( r = 0 \), it reaches its maximum, 0.5\( V \), which is independent of \( \delta \). An increase in \( r \) only lowers the level slightly. For instance, even when \( r = 1 \) and \( \delta = 2.61 \), the level is 0.49\( V \), which is much greater than the maximum 0.42\( V \) under the contingent fee. Comparing the two total effort levels of the players, we obtain Proposition 2.

**Proposition 2.** Player 1's choice of the hourly fee makes players 1 and 2 together expend more effort, compared with her choice of the contingent fee.
The intuition behind Proposition 2 is due to the delegation argument: A principal can benefit by using a delegate whose objective function differs from hers. Since player 2 adopts the hourly fee, player 1's adoption of the contingent fee makes her agent's objective function differ not only from player 1's objective function but also from agent 2's, which makes competing agents less aggressive. If player 1 chooses the hourly fee, the delegation argument weakens, compared with her choice of the contingent fee.

Proposition 2 draws a policy implication for a government that has to introduce an institution to support credit-constrained plaintiffs. If the government wants to reduce the level of litigation costs (or, equivalently, to increase the sum of both players' expected payoffs), then the introduction of the American practice may be a better choice than that of the European one.16

6. Concluding remarks

We have modeled a lawsuit as a contest with delegation under the assumption that a credit constraint may be binding for player 1 (a plaintiff) but not for player 2 (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 an hourly-fee basis. Then we have compared the two models.

Assuming a government that has to introduce an institution to support credit-constrained plaintiffs, we have found: (i) If the government wants to help the plaintiffs maximize their expected payoffs, it may be better to introduce legal expenses insurance than to allow the practice of contingent fees; (ii) If the government's objective is to reduce the level of litigants' legal expenditures, the introduction of contingent fees may be a better choice than that of legal expenses insurance. This trade-off between the introduction of contingent fees and that of legal expenses insurance sheds light on the Japanese and Korean jurisdictions that need either contingent fees or legal expenses insurance.17
In the real world, a plaintiff is often a credit-constrained individual who also has no experience in litigation before. But a defendant is usually a firm that has a deep pocket and a lot of litigation experience. This may bring a couple of asymmetry between the plaintiff and defendant. First, the defendant with a deep pocket 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, some extensions of our model seem important by assuming that: (i) the agents are differentiated by their ability and player 2 has better access to abler agents than player 1, and/or (ii) 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 popular belief, Kritzer (2002) reports that contingent fees are not a uniquely American phenomenon. He finds that actually contingent fees have been permitted, though very limitedly, in some countries such as Australia, Canada, France, Ireland, Japan, New Zealand, and Scotland.

2. Contest models have long been adopted to analyze lawsuits: Plott (1987), Katz (1988), Farmer and Pecorino (1999), Wärneryd (2000), and Hirshleifer and Osborne (2001) to name a few. But unlike these papers, we add two lawyers to whom the plaintiff and defendant delegate a lawsuit.

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 two reasons why we model a lawsuit as a contest with a logit-form litigation success function. First, 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, a party with greater effort is not guaranteed victory, but rather has a greater likelihood of victory. The logit-form litigation success function is 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 prevails, however, unrelated to the amount at stake (see Hyde 2006; Emons, 2007). Emons and Garoupa (2006) 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 delegation argument has long been emphasized in many contexts: Fershtman and Judd (1987), Baik and Kim (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. As a referee correctly points out, the equilibria in this kind of rent seeking game are inefficient as long as lawyers' effort is socially undesirable. In the efficient allocation, both lawyers exert no effort and a party's probability to prevail is one half. But this is not a Nash equilibrium because a party gains by unilaterally deviating. If the efficiency is the only concern of the government, it can easily implement the efficient allocation by forbidding contingent fees or legal insurance. Then a plaintiff, facing a credit constraint, cannot sue. The society does not waste costly effort by lawyers. But this is totally unfair because, with the same degree of fault that we have assumed, the plaintiff who deserves one half of damages gets nothing. Thus, if the government wants to care for the fairness as well as the efficiency, it should help the credit-constrained plaintiff by introducing contingent fees or legal expenses insurance. Then, lawyers' effort becomes socially desirable, though maybe not efficient, because it contributes to the fairness by making the true degree of fault clear.

9. This describes the fact that in the real world a corporate defendant with a deep pocket chooses the hourly fee when both the contingent and hourly fees are feasible. This may be because she is better off under the hourly fee than under the contingent fee.

10. In the United States, the contingent-fee fraction $\beta$ is conventionally about one-third of the recovery (see Hay, 1997; Posner, 1998, pp. 624-632; Baik and Kim, 2007). In the real world, it is impossible for player 2 to see the exact value of $\beta$. This is because the contract for $\beta$ is a kind of privileged communication or document between player 1 and agent 1. In the United States, the privilege prohibits even a court from compelling a lawyer and his client to reveal their confidential communication. Thus, player 1 may have an incentive to use this information gap to her advantage. To reflect this situation, it is reasonable to assume that player 2 does not have perfect information on $\beta$. For example, player 2 knows only that $\beta$ is drawn from a probability
distribution and that its mean value is one third. For the sake of analytical simplicity, however, this paper does not pursue this case by assuming perfect information on \( \beta \).

11. Note that agent 1 chooses \( x_1 \) on his own, but agent 2 does not. Since agent 2 is hired under the hourly fee, it is player 2 who chooses \( x_2 \).

12. If \( \delta \) denotes a possible overcharge rate instead of the monitoring cost rate, \( \pi_2 \) equals \( \delta x_2 \).

13. In contrast, under the British rule, the loser reimburses the winner for her litigation costs including the lawyer's fees. In Japan and Korea, there is the reimbursement by the loser. But the reimbursement amount of the lawyer's fees approved by courts is very small, compared with that in the United Kingdom. For instance, the Korean Supreme Court allows only 0.5% of the award as the reimbursement of the lawyer's fees if the award exceeds about $100,000 (The Korean Supreme Court Regulation No. 1829: Regulations on the Fee-shifting Rule, June 9, 2003). The Japanese jurisdiction allows only 0.3% if it exceeds about $80,000 (The Third Appendix Table regarding Articles 4 and 28, The Japanese Civil Procedure Cost Act). These reimbursement amounts are about 1/30 to 1/20 of the actual lawyer's fees. We are thus able to say that the actual fee-shifting rules in Japan and Korea are far from the British rule, but substantially close to the American rule. Besides, 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.

14. To simplify the exposition, this paper limits the role of insurance companies to that of lenders, ignoring strategic interactions between litigants and insurance companies. See van Velthoven and van Wijck (2001) and Heyes, Rickman and Tzavara (2004) for the strategic role of insurance companies.

15. What would be the value of \( \delta \) in the real world? To the best of our knowledge, however, data on \( \delta \) are not available. But the degree of moral hazard could take a form of overcharge rate, as explained in Section 3. Interestingly, Kritzer (1990, pp. 135-161) 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, then \( \delta = (49.5 - 45.7)/45.7 = 0.08 \), which is much less than 0.78.

16. The implication of Proposition 2 holds under the condition that the contingent fee does not bring more lawsuits than the hourly fee. Miceli (1994) argues that it is ambiguous whether or not the contingent fee leads to more suits than the hourly fee. Moreover, 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.

17. We could not get Chinese documents on the cost allocation rule. But a few Chinese scholars and lawyers, including Dr. Qiao and Mr. Chu in the acknowledgments of the paper, informed us that the Chinese rule is very close to those of Japan and Korea explained in footnote 13. If so, the policy implications of the paper also apply to the Chinese jurisdiction.
References


Figure 1. The players' equilibrium expected payoffs when $r = 0$. 