

Introduction to Law and Economics: Lawyers and Fee-Shifting Rules

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Introduction

- Lawyers play crucial role in litigations.
- Their behavior is therefore regulated.
- Regulations in U.S.:
 - (i) Model Rules of Professional Conduct
 - (ii) Restatement of the Law Concerning Lawyers.
- Taiwan: 律師法 (L), 律師倫理規範 (E)

- Two goals in regulating lawyering
 1. Ensuring effective representation of client
 - (i) Render diligent and competent service. (E 5, 7, 26, 29)
 - (ii) Comply with clients decisions. (E 27, 40)
 - (iii) Keep confidential information they acquire during presentation. (E 33)
 - (iv) Avoid cases with conflict of interests. (E, 4, 5 章)

2. Avoiding abuse of non-clients and court system

- (i) May not assert claims or defense without foundation. (E 39)
- (ii) May not use false evidence. (E 23)
- (iii) May not destroy or withhold evidence sought by valid subpoena or discovery request. (E 23)
- (iv) May not make certain types of argument (e.g., racial or gender prejudice) to a jury.
- (v) May not contact another party who has a lawyer without that lawyer's permission. (E 41)

Introduction

- Regulations are sometimes hard to follow.
- But a simple rule: The lawyer is to advance the client's interests by all means not plainly unlawful.

Lawyer as an Agent

- In reality, there is enormous conflict of interests between lawyer and client.
- Lawyer serves as an agent to the client.
- In economics terminology, lawyer is “agent” and client is “principal”, and there is “agency cost”.

- Some principal-agent theory:
 1. Though agent acts on behalf of principal, he has divergent interests.
 2. Principal cannot observe or monitor agent's action.
 3. Payment to agent must therefore rely on certain measure of performance.
 4. Performance measure is imperfect.
 5. There is inefficiency arising from the principal-agent or, in our context, lawyer-client relationship.

Lawyer as an Agent

- Three commonly adopted contracts for lawyer
 1. Hourly fees: Lawyer paid by the time spent working.
 2. Fee-for-service: A fixed charge for every task performed.
 3. Contingency fees: Payment depends on the outcome of the dispute.
- 台北市律師公會章程第 29 條
- Efficiency requires lawyer to work in a way to maximize joint profit of client and lawyer.
- This requires
marginal joint profit = marginal cost of effort.
- Problem: either lawyer's pay is independent of joint profit or only a fraction of it.

Hourly Fee

- Internalizes the cost of lawyer's effort, but externalizes its benefit.
- Therefore, too much effort (too many hours).
- In particular, lawyer will be too zealous in pursuing litigation, rather than settlement.

Fee-for-Service

- Internalizes cost, but externalizes benefit.
- Result: Too little effort on too many tasks.
- Inefficient.
- An extreme form of fee-for-service is flat fee, in which a fixed fee is paid for the whole litigation.
- In that case, only reputational concern renders incentives to lawyer.

Contingent Fee

- A general practice in U.S. civil litigation is for lawyer to receive $1/3$ of the plaintiff's recovery.
- Note that the lawyer gets nothing if case is lost.
- This internalizes the cost of lawyer's effort, but only partially internalizes the benefit (only one-third).
- Usually, the lawyer spends less-than-efficient effort.
- In particular, lawyer settles too easily.
- As with the lesson of the principal-agent theory, no payment contract is efficient.

Lawyer's Incentive to Reveal Information

- In addition to providing effort, the lawyers also provide information as basis of their clients' decision-making.
- A lawyer should provide information, and advise client, in a way that a case is litigated if and only if its expected benefit exceeds cost.
- Similar to the case of effort, all three types of contract provide inefficient incentives for lawyer to reveal information.

Lawyer's Incentive to Reveal Information

- Lawyers paid by hour, or by service performed, might exaggerate the merit of the case, leading to pursue a case with negative expected payoff. (Resulting in a false positive.)
- Lawyers paid by contingent fee, on the contrary, have incentive to persuade client to drop a case which has positive expected payoff. (Resulting in a false negative.)

Fee Indemnity

- Fee indemnity rule, or a fee-shifting rule, regulates the extent to which the losing party should cover the litigation cost of the winning party.
- Two leading regulations: American rule and the English (British) rule.
- American rule: The litigants pay for their own costs.
- British rule: The losing party must pay for the winner's cost.

American vs. British Rule: An Example

- The damage of an accident is d .
- Plaintiff win-rate in court is p .
- Let S denote the settlement amount.

American vs. British Rule: An Example

- The outcome of litigation for the plaintiff under the **American rule** and the British rule.



- The outcome of litigation for the defendant under the **American rule** and British rule:



American vs. British Rule: An Example

- For either the plaintiff or the defendant, payoff is lower when losing and higher when winning under the British rule than the American rule.
- British rule is more risky for both parties.
- Since the win-lose gap is wider under the British rule, litigants spend more resource during litigation.
- The indemnity rule also affects the possibility of settlement/litigation.
- Question: When does the American/British rule lead to more settlement?

Effect of Indemnity Rule on the Incentives to Settle/Litigate

- Under the American rule, the region of settlement is $[pd - c_p, pd + c_d]$.
- Under the British rule, the maximum (resp. minimum) that the defendant (resp. plaintiff) is willing to pay (resp. receive) as settlement is $(1 - p)(d + c_p + c_d)$ (resp. $pd - (1 - p)(c_d + c_p)$).
- The region of settlement is therefore $[pd - c_p + pc_p - (1 - p)c_d, pd + c_d + pc_p - (1 - p)c_d]$.

Effect of Indemnity Rule on the Incentives to Settle/Litigate

- Range of settlement for the American rule is

$$pd + c_d - (pd - c_p) = c_p + c_d.$$

- Range of settlement for the British rule is

$$\begin{aligned} & [pd + c_d + pc_p - (1 - p)c_d] \\ & - [pd - c_p + pc_p - (1 - p)c_d] \\ & = c_p + c_d. \end{aligned}$$

- The British and American rules have exactly the same length for the range of settlement.
- If $pc_p > (1 - p)c_d$, the range of settlement is on the right for British rule, making possible settlements to be higher.

Effect of Indemnity Rule on the Incentives to Settle/Litigate

- When either litigant is risk-averse, the English rule will provide stronger incentive to settle.
- All in all, compared to the American rule, the British has higher settlement rate. However, litigants spend more resource when they do litigate.

Taiwan and China

- In Taiwan (and China also), at the time the plaintiff formally files a case, he must pay a court fee which equals about 1% of claim.
- When the judge eventually gives the verdict, he will write in the judgement what percentage each party is responsible for this fee.
- This represents, in the judges' opinion, each party's liability to the damage in dispute.
- Therefore, the plaintiff (or defendant) does not simply “lose” or “win”, but bears a certain percentage of damage.