

**ALLOWING LAWYERS TO CHARGE CONTINGENCY FEES:
IMPACT ON THE LEGAL SERVICES MARKET**

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I. INTRODUCTION

A contingency fee is a contractual arrangement between a client and an advocate in which the advocate's fee depends on the outcome of the case.¹⁵⁹ The lawyer agrees to make his fee contingent upon the success of his representation and recovery of a sum of money and the fee charged is a percentage of the recovery.¹⁶⁰ While this system is prevalent in countries like the USA, Canada, South Korea etc., India does not allow charging contingent fees. The Bar Council of India strictly prohibits the lawyers from charging contingent fees to their clients.

“Rule 20: An advocate shall not stipulate for a fee contingent on the results of litigation or agree to share the proceeds thereof.”¹⁶¹

Such agreements are believed to adversely affect advocate's ability to act objectively and in a detached manner as an officer of the court and are considered to hinder the administration of justice. Having a financial interest in the outcome of the case may create perverse incentives for lawyers to resort to unscrupulous practices in order to win the case, which would be detrimental to the interests of justice. It is primarily for such ethical considerations that contingency fees arrangements are not allowed in India.

This essay attempts to study the impact on various stakeholders of the market for legal services, if contingency fees arrangements are allowed in India. The analysis has been done from the perspective of economic efficiency only. The ethical concerns arising from

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¹⁵⁹ THE NEW PALGRAVE'S DICTIONARY OF ECONOMICS AND THE LAW, 67 (Peter Newman ed., 1998).

¹⁶⁰ Adam Shajnfeld, *A Critical Survey of the Law, Ethics, and Economics of Attorney Contingent Fee Arrangements*, 54 N.Y. L. REV. 773, 774 (2009).

¹⁶¹ Rule 20, Chapter II, Part VI, Bar Council of India Rules on Professional Conduct (As amended up to September 30, 2009).

such systems remain out of the scope of this essay. Section one traces the effect of contingency fees system on the litigants; section two deals with the possible advantages which lawyers can derive from such arrangements; section three studies how the government and the court machinery will benefit from this arrangement and the last section focuses on the problems that can arise out of such agreements.

II. IMPACT ON LITIGANTS

2.1. ACCESS TO COURTS

Contingency fee arrangements have been justified on the grounds of increasing access to litigation. They enable the impecunious to obtain representation in courts.¹⁶² Litigation costs are usually incurred before the final judgement is reached, including costs to bring the case, the delay associated and risks faced. In the current system, lawyers charge for these costs in advance. This implies that those facing difficulty in raising funds are discouraged from pursuing their cases. This defeats the purpose of legal system to compensate the injured party as well as to deter the future injurers.

A recent study conducted by DAKSH concluded that average cost incurred by civil litigant (plaintiff) in India is as high as Rs. 465 per day.¹⁶³ Free legal services offered under the National Legal Services Authority Act, 1987 is not availed by many. The study revealed that despite a considerable number of litigants from lower income groups, only 2.36% of all litigants relied on court-appointed lawyers.¹⁶⁴ This can be attributed to poor legal literacy and awareness among the public at large, and to the inefficiency of the government in proper utilisation of funds allocated for legal aid. The current system of legal aid also does not cover members of middle and upper socio-economic classes who may find it difficult to pay hefty legal fees in advance of success of the case. Moreover, the incentives for lawyers to provide free legal aid under the National Legal Services

¹⁶² Shajnfeld, *supra* note 160, at 775.

¹⁶³ DAKSH, *The State of the Indian Judiciary: A Report by DAKSH*, (2016), http://dakshindia.org/state-of-the-indian-judiciary/08_contents.html (Last visited on June 4, 2019).

¹⁶⁴ *Id.*

Authority are insufficient. Contingency fee arrangements on the other hand, will enable such individuals of lower income strata to finance their litigation.

Contingency fees can help overcome the financial limitations by enabling those who cannot afford the cost of litigation to not pay fees unless and until it is successful. These arrangements do not require payment of fees in the event of losing the case and thus, encourage injured parties to litigate.¹⁶⁵ The mechanism can also be helpful for the litigants who are constrained by liquidity and cannot finance litigation on their own.¹⁶⁶ It is thus a cost-spreading solution to the access-to-justice problem plaguing India. The litigant bears the expected cost of winning the case while the lawyer bears the expected cost of losing.¹⁶⁷ This reduces the cost of litigation that the litigants have to bear.

2.2. PRINCIPAL-AGENT PROBLEM

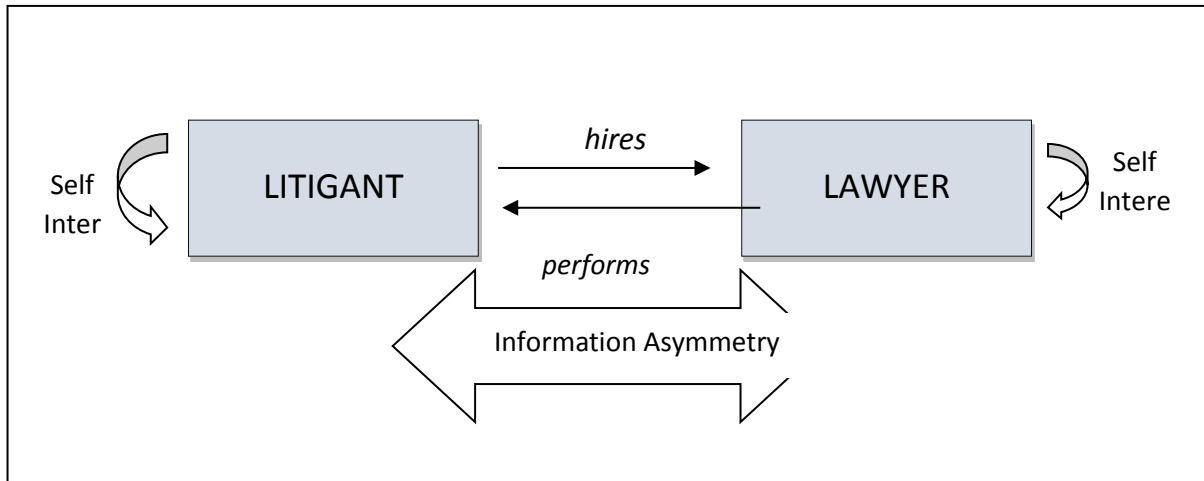
Contingency fees arrangements help solve the *principal-agent problem* which occurs when one party (agent) represents and takes decision on behalf of another and that has an impact on another (principal). There may arise a conflict due to divergence of interests of both the parties. Further, due to information asymmetry with the agent having more information than the principal, the principal is likely to incur *agency cost*. In the market for legal services, this problem arises between lawyers who act as the agents of their clients. The clients are not in a position to monitor lawyers' inputs and ascertain the value of their services. This information symmetry gives way to a possible difference in their interests which leads to a situation where lawyers take decisions that benefit them rather than their client.

The legal profession is considered to be a noble one where the lawyer should prioritise client's interests over his. In other words, ethics must prevail over self-interest of lawyers. However, this is a normative ideal rarely met in practice and the legal services market is

¹⁶⁵ Neil Rickman, *The Economics of Contingency Fees in Personal Injury Litigation*, 10(1) OXFORD REV. OF ECON. POL'Y 34, 37 (1994).

¹⁶⁶ Jennifer Arlen, RESEARCH HANDBOOK ON ECONOMICS OF TORTS 390 (2013).

far from the perfect market.¹⁶⁸ The intricacies of the legal system and formalities involved in it facilitate opportunism on the part of lawyers. Hence, it becomes all the more important to align the interest of lawyers and their clients.



2.2.1. Information Asymmetry:

Legal services are essentially credence goods. A credence good is one whose utility is difficult to measure, even after consumption. It arises when an expert knows more about the type of good or service that the consumer needs than the consumer himself.¹⁶⁹ Lawyers are in a better position to provide legal services and ascertain how much to provide. The complexity of the legal system makes it difficult to for the client to determine the strength of his case and value of the services provided by the lawyer, even after the case is over. This gives rise to an information asymmetry between lawyer and his client, creating incentives for opportunistic behaviour on the part of the lawyer.

Further, the client also may have private knowledge about the facts of his case when he brings it to a lawyer and he could hide any adverse information so as to induce the lawyer to take the case. Contingency fees can resolve this information asymmetry by allowing

¹⁶⁷ Charles Rickett and Thomas Telfer, INTERNATIONAL PERSPECTIVES ON CONSUMERS' ACCESS TO JUSTICE 318 (2003).

¹⁶⁸ Gillian K. Hadfield, The Price of Law: How the Market for Lawyers Distorts the Justice System 98(4), Michigan Law Review 953, 962 (2000).

the lawyer and client to signal their personal information via the share of contingency fee they offer or accept. In other words, the more risk they are ready to bear, the more favourable their private information must be. Therefore, a good lawyer will charge higher contingency fees, while a well-informed client with a strong case will be willing to pay a lower contingency percentage and vice-versa.¹⁷⁰

2.2.2. Market Failure

The goal of the litigant is maximisation of the amount recovered as damages or compensation, which depends on the lawyer's efforts and other factors out of his discretion, such as opposite party's efforts, court's discretion etc. Further, the client cannot monitor the efforts of the lawyer.

The table below illustrates this. It shows that the lawyer can work with either low or high amount of effort. Low effort generates either Rs.1,00,000 or Rs. 2,00,000 of compensation (with equal probability) while high effort produces Rs. 2,00,000 or Rs.4,00,000, depending on the random factors. The higher recovery is labelled as 'Good Luck' and the lesser one as 'Bad Luck'. These numbers highlight the problem of asymmetrical information: when the recovery is Rs. 2,00,000, the client cannot ascertain the effort level of the lawyer. This leads to a situation of market-failure in the legal services market.

Amount Recovered after the Success of Trial		
	<i>Bad Luck</i>	<i>Good Luck</i>
Low Effort	Rs. 1,00,000	Rs. 2,00,000
High Effort	Rs. 2,00,000	Rs. 4,00,000

¹⁶⁹ Uwe Dulleck and Rudolf Kerschbamer, *On Doctors, Mechanics, and Computer Specialists: The Economics of Credence Goods*, 44 J. OF ECON. LITERATURE 5, 6 (2006).

¹⁷⁰ DANIEL L. RUBINFELD AND SUZANNE SCOTCHMER, *CONTINGENT FEES FOR ATTORNEYS: AN ECONOMIC ANALYSIS*, 24(3) THE RAND J. OF ECON. 343, 350 (1993).

2.2.3. Incentives in the principal-agent framework¹⁷¹

A general consequence of principal-agent theory is that, when the effort is unobservable, a payment mechanism which rewards the outcome of the effort rather than the effort itself will be more efficient.¹⁷² The lawyer's goal is to maximise the payment for his services minus the cost that he incurs in the process. When the payment system is based on efforts, the lawyers internalize the cost of their efforts but not the results. In such an efforts-based payment system, they have incentives to put in inadequate efforts. Because the lawyer's pay is largely unaffected by the outcome of the case, it leads to inefficiency and market failure.

Consequently, it will be more efficient to award the lawyer for his productive efforts which can be done by giving him a stake in the outcome of the case. This will align the interests of the lawyer and the client. Both the lawyer and the client will be better off since it will give the lawyer an incentive to put in higher efforts which in turn, will help the client recover a larger amount. The same is graphically exemplified as below.

Let, x =lawyer's effort level; A = award, P_p = probability with which litigant expects to win the case¹⁷³and C_p = the costs incurred in litigation.

The expected value¹⁷⁴ of trial for the litigant = $AP_p(x) - C_p(x)$,

where $P_p(x)$ and $C_p(x)$ are increasing functions of x since it is assumed that the probability of success at trial depends on his lawyer's effort level.¹⁷⁵

Costs at trial are incurred by the lawyer. The optimal effort level will be x^* , where the difference between costs incurred and the expected value of the amount recovered is the highest. Under fixed fee system, the lawyer will get remunerated irrespective of his effort level, giving him incentive to minimize his efforts. Under contingency fees system, the

¹⁷¹ R.S. Pindyck et al, MICROECONOMICS, 583 (7thedn., 2009).

¹⁷² Rickman, *supra* note 165, at 37.

¹⁷³ Francisco Cabrillo and Sean Fitzpatrick, THE ECONOMICS OF COURTS AND LITIGATION 165 (2008).

¹⁷⁴ Expected value is probability weighted average of the payoffs associated with all possible outcomes. *See*, R.S. Pindyck et al, MICROECONOMICS, 597 (7thedn., 2009).

lawyer is given a stake in the outcome of the case, denoted by b . A rational lawyer will choose an effort level to maximize his own returns. Therefore, the lawyer maximizes $bAP_p(x) - C_p(x)$, which will lead to a positive effort level, xb .¹⁷⁶

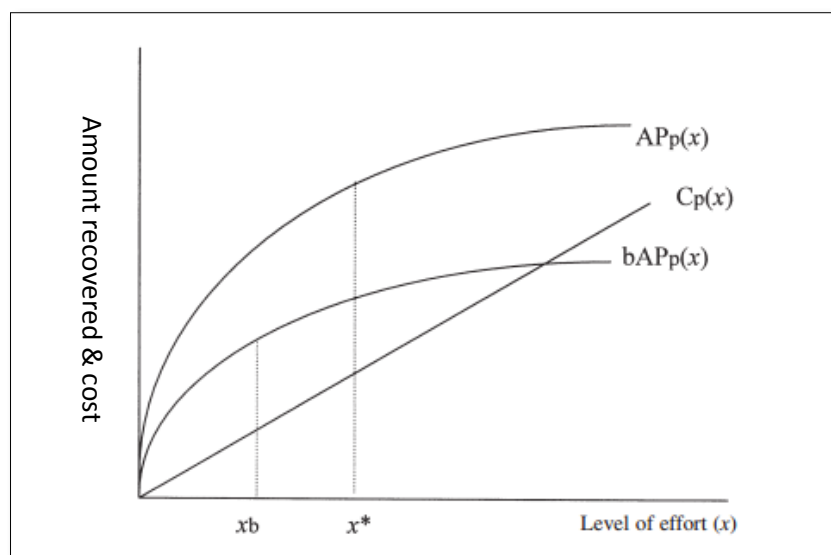


Figure 1: Contingent Fees and Lawyer's effort¹⁷⁷

2.3. RISK-SHARING

Contingency fee arrangements act as risk-sharing instruments in as much as they shift the risk of negative returns from litigants to the lawyers. It is based on the assumption that lawyers are risk-neutral since they work on multiple cases at once. For a client, all his risk is associated with one case but a lawyer invests his time and efforts in several cases at once, the outcomes of which are usually not correlated, allowing him to diversify the risk.¹⁷⁸ Also, lawyers, with their expertise are better equipped to assess the prospects of a case and the risks associated with it. Shifting uncertainty away from a risk-averse client to a risk-neutral lawyer leads to more efficient allocation of risk and higher social welfare.

This can also give way to the lawyers 'buying' the claim from their clients, which is the most optimal solution to the principal-agent problem. Figure 2(b) shows the utility curve of risk-averse client. I_w is the amount of recovery on winning the case while on losing,

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

¹⁷⁷ *Supra* note 173 (Graph).

nothing is recovered ($I=0$). Line OA shows the total expected utility derived from pursuing the claim. The expected outcome is I_E which gives an expected utility U . To receive the same level of utility, the client is willing to give up the claim for a certain amount of I_1 (the fixed sum which lawyer will pay the client to buy the claim from him). Figure 2 (a) shows the risk-neutral lawyer who is indifferent between his actual utility and expected utility. With an initial income level of I , he will be willing to buy the case when $I - I_1 + I_E > I$ or $I_E > I_1$. The utility loss of risk-averse client from lower payoff will be offset by utility gain from certainty. It is a Pareto efficiency gain since the lawyer is better off without the client being worse off.¹⁷⁹

However, such ‘buying’ of claim can cause the insured plaintiff to lose interest in the claim which can deprive the lawyer of his necessary cooperation;¹⁸⁰ nor is it permissible in India.

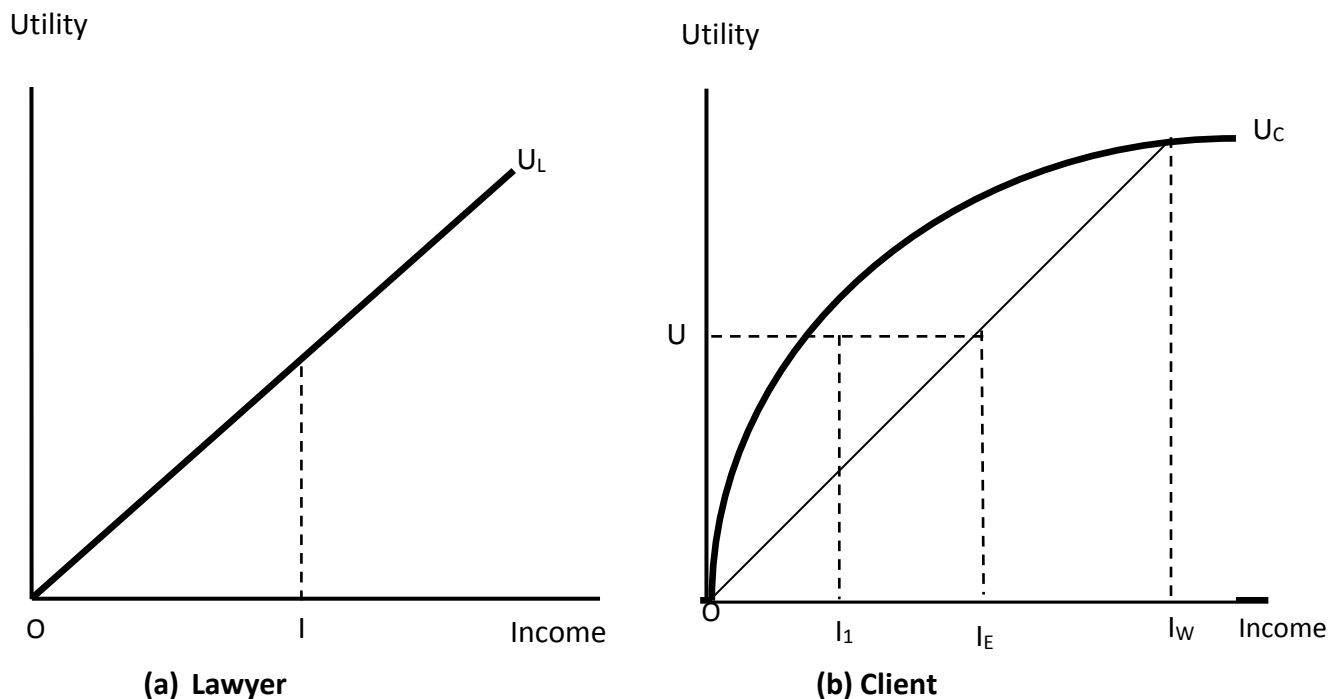


Figure 2: Risk sharing between risk-averse client and risk-neutral lawyer¹⁸¹

¹⁷⁸ Diversification is the practice of reducing risk by allocating resources to a variety of activities whose outcomes are not directly related.

¹⁷⁹ Rickman, *supra* note 165, at 38.

¹⁸⁰ Patricia Munch Danzon, *Contingent Fees for Personal Injury Litigation* 14(1) THE BELL JOURNAL OF ECONOMICS 213, 220 (1983).

III. IMPACT ON LAWYERS

3.1. THE CONCEPT OF RISK

For a lawyer, a contingency fee arrangement acts as a risky asset, yielding income if the trial is successful.¹⁸² The riskier an asset is, the higher will be the expected return on it. This is analogous to the concept of finance where riskier investments command higher return rate.¹⁸³ Therefore, contingency fee will generate higher returns for the lawyer as a compensation for accepting the risk of being inadequately paid for the services provided or of not being paid at all. The lawyers will charge not only for their efforts they put in but also for bearing the risk. Under contingency fee arrangements, the lawyer has to bear the following risks –

1. Getting an inadequate award which is unable to meet the costs, though the case is won.
2. The absence of payment when the case is lost.
3. The compensation is adequate but the defendant is unable to pay it.
4. Laws in question change to the disadvantage of the plaintiff while the case is pending.

The aforementioned possibilities constitute the risk element in lawyer's fees which entitles him to charge a rate higher than normal.

3.2. ENTRY TO THE MARKET

Contingency fee can enhance the business prospects of a new entrant in the legal services market. As established in Section I, price sensitive clients who cannot afford paying the high fee of established lawyers can avail to this payment mechanism and create a prospective client base for a new lawyer. It also allows the clients to partner their risks with the lawyers which can attract risk-averse clients who refrain from instituting a suit due to the risks involved. Further, these arrangements can address the information

¹⁸¹ Rickman, *supra* note 165, at 38.

¹⁸² A risky asset is an asset that provides an uncertain flow of money or services.

asymmetry concerns of the client who can now rely on a lawyer whose interests are aligned with those of the client and who will put in efforts in furtherance of a common intention. This will help a new lawyer who will find it relatively easier to win a client's trust.

IV. IMPACT ON THE COURT MACHINERY

4.1. FRIVOLOUS LITIGATION

Contingency fee can help in reducing frivolous litigation. Under hourly or fixed fee arrangements, lawyers bear little risk which may induce them to take cases which are largely meritless. However, under contingency fee, lawyers bear a greater risk, which can discourage them from taking cases that have no merit. By resting lawyers' compensation on the success of the case, they are given an incentive to function as gatekeepers of the court machinery. They can assess the cases for their merit and will pursue only those which are likely to succeed.¹⁸⁴ This is based on the assumption that lawyers have greater knowledge and expertise to determine the merits of the case and likelihood of its success than the clients. Indian judiciary is already burdened with 88,53,981 pending civil cases.¹⁸⁵ Allowing contingency fees arrangements will address the problem of frivolous and vexatious litigation to an extent.

4.2. LEGAL AID

Contingency fee mechanism helps in sharing risk between the public purse and lawyers since it reduces the costs of legal aid.¹⁸⁶ In India, free legal services are provided under Legal Services Authorities Act, 1987. Legal Services Authorities provide the eligible applicant with counsel at the expense of State, pay the required court fee and all other

¹⁸³ Shajnfeld, *supra* note 160, at 777.

¹⁸⁴ *Id.*

¹⁸⁵ NATIONAL JUDICIAL DATA GRID, http://njdg.ecourts.gov.in/njdg_public/main.php (Last visited on June 4, 2019).

¹⁸⁶ *Supra* note 173, at 170.

incidental expenses related to the case. The person endowed with legal aid, therefore, is not required to pay anything for the litigation.

Figure 3 below shows the budgetary allocation for National Legal Services Authority to provide legal aid to the poor and disadvantaged. Apart from budgetary allocation, the 13th Finance Commission awarded a special grant of Rs.300 Crores over a period of five years (2010–2015) for legal aid scheme. However, only Rs.68 Crores of the allocated budget has been utilised which shows inefficiency on the part of the government.¹⁸⁷The government, by allowing contingency fee, will substitute the need of funding free legal aid and still solve the access-to-justice problem in cases which involve damages to be recovered, as explained earlier.

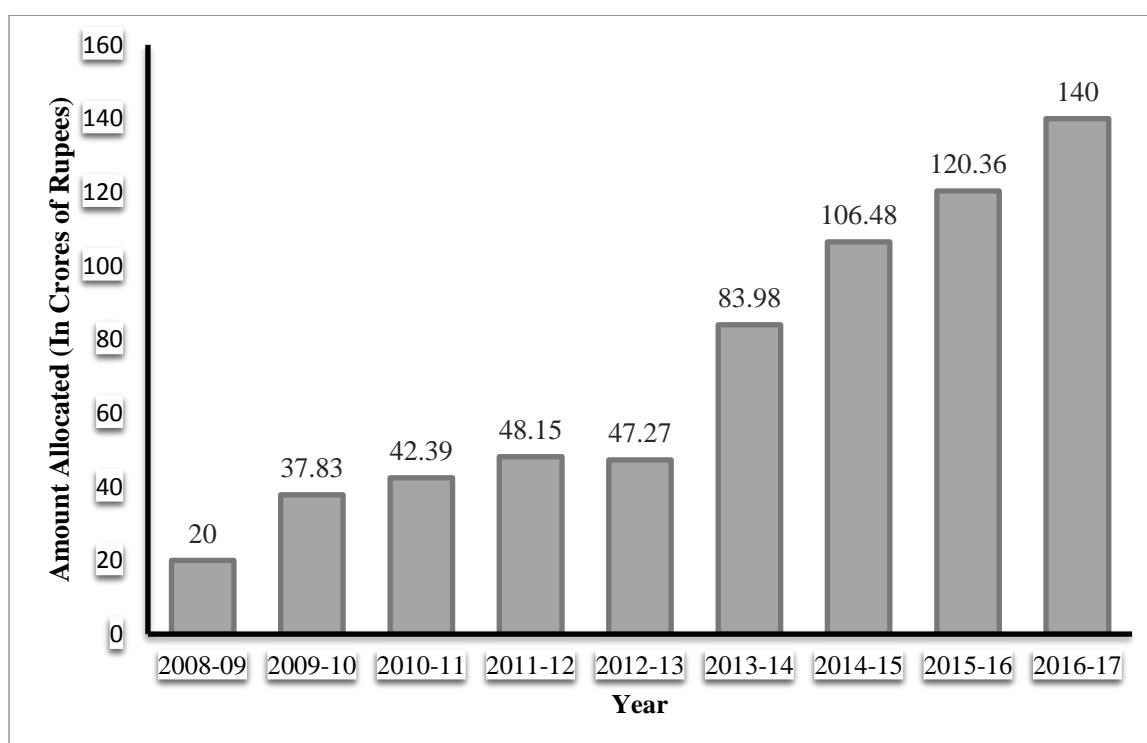


Figure 3: Union Budget Allocation for the National Legal Services Authority¹⁸⁸

¹⁸⁷ *Improving Justice Delivery: Ready Reckoner on Thirteenth Finance Commission Grant, Government Orders and Guidelines Issued by the Government of India* (2011), MINISTRY OF LAW AND JUSTICE, http://doj.gov.in/sites/default/files/READY%20RECKONER%20TFC%281%29_5.pdf (Last visited on June 4, 2019).

¹⁸⁸ Sources of Funding, NATIONAL LEGAL SERVICES AUTHORITY, <https://nalsa.gov.in/content/funding> (Last visited on June 5, 2019).

V. THE SHORTCOMINGS

This section discusses the problems that allowing contingency fee arrangements can pose. They require the lawyer to be sure that the cases they take have sufficiently high expected value which can cover the opportunity costs of their time and risk-bearing. Consequently, the cases with high expected value will be viewed more favourably by them over the ones which do not have these characteristics.¹⁸⁹ This challenges the access-to-justice justification of contingency fee.

Another argument is that instead of aligning the interests of lawyers and clients, contingency fee present each with different incentives. This can prejudice the lawyer's advice on important decisions such as whether to file a case or to settle it. As the lawyer pays the costs of the case, he may be tempted to settle the case early before running the risk and costs of going to trial.¹⁹⁰ This may work against the client's interests. Conversely, the client may wish to settle early in need of money while the lawyer may want to delay it in hopes of greater recovery.

Contingency fee can also induce 'ambulance-chasing' behaviour in lawyers. Ambulance-chasing is a blatant form of solicitation in which a lawyer uses undue pressure to persuade injured people to employ the lawyer to represent them. Contingency fee system would incentivise lawyers to actively seek cases now that they have a direct financial interest in the outcome of the case.¹⁹¹

Further, plaintiffs may be encouraged to try their chance with any kind of claims since contingency fee shifts the risk of negative outcome to the lawyer. Encouraged by this, some advocates, in the hopes of obtaining an early settlement may overlook the strength assessment of a case and file frivolous lawsuits.

¹⁸⁹ Rickman, *supra* note 165.

¹⁹⁰ *Id.*

¹⁹¹ *Id.*

Contingency fee arrangements have also raised ethical concerns. Direct financial interest in case may cause an advocate to abdicate his responsibility towards the court. Another apprehension, especially in Indian context is that it may lead to exploitation of clients with lawyers, superior in skill and knowledge, charging exorbitant fee and unlike in developed nations, the literacy and awareness level of clients in India are low.

VI. CONCLUSION

This article studied the implications of allowing the lawyers in India to charge contingency fee. Largely, this system tends to make the legal services market more efficient. It provides a solution to the access-to-justice problem, thus increasing the social welfare. It corrects for the market failure arising out of information symmetry and principal-agent problem and leads to efficient allocation of risk between the risk-averse client and risk-neutral lawyer. However, this result may change where the clients have different preferences toward risk. These justifications of contingency fee promote consumer welfare.

Contingency fee arrangements allow the lawyers to charge higher fee as a compensation for the risk they bear. This however, can also tempt them to exploit clients who have lesser knowledge. Prohibition on contingency fee serves as a barrier to entry in legal market; allowing them can be advantageous for a new lawyer. Further, contingency fee can help reduce frivolous litigation and can also substitute the legal aid which the government in India has otherwise not been very efficient in providing. Therefore, contingency fees can help promote social welfare.

While the arrangement has its shortcomings, regulations in terms of regulating the type of cases where lawyers can charge contingency fees and fixing a maximum percentage of recovery as fees can help overcome them. A deeper study of the existing models of contingency fees in countries like the USA can help draw valuable inferences and understand the implications of such mechanism in India better.

Contingency fees system can be introduced in India with regulations in order to maximise welfare of the stakeholders. The regulations can be specifying or limiting the kind of cases in which contingency fee can be charged. For instance, in the U.S., contingency fees is barred in criminal suits and domestic relations matters such as divorce.¹⁹² The regulations can also prescribe the percentage of contingency fees that can be charged. These regulations largely stem out of ethical considerations, with the objective of promoting social welfare. Economic impact of such regulations in India are out of the scope of this essay but must be explored in future before a system of contingency fees is brought in.

Thus, contingency fees arrangements can prove to be useful and important provided they are structured in a way to maximise the advantages and minimise perverse incentives and effects. This would promote an economically efficient market for legal services in India.

¹⁹² Rule 1.5(d), American Bar Association Model Rules of Professional Conduct.