Neither Saints Nor Devils: A Behavioral Analysis of Attorneys' Contingent Fees

Eyal Zamir, Hebrew University of Jerusalem
Ilana Ritov, Hebrew University of Jerusalem

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ABSTRACT

The market for legal services, and particularly lawyers’ Contingent Fee (CF) arrangements, have been extensively studied from legal, economic and sociological standpoints, but curiously not from a behavioral perspective. Building on Kahneman and Tversky’s Prospect Theory, this paper presents a series of experiments designed to reveal people’s preferences regarding attorneys’ fees and their perceived fairness.

Contrary to common economic wisdom, we demonstrate that loss aversion (rather than risk aversion or incentivizing the lawyer to win the case) plays a major role in clients’ preferences for CF. Facing a choice between a mixed “gamble” and a pure positive one, plaintiffs prefer CF even if it yields an expected fee that is two or three times higher than a non-contingent one. At the same time, defendants, who face a choice between two pure negative gambles, are typically risk seeking and prefer fixed fees. Our findings indicate that information problems and lack of alternatives probably do not loom large on clients’ preferences regarding fee arrangements. Proposals to impose stricter pre-contractual disclosure duties on attorneys or requiring them to offer prospective clients a choice between different fee arrangements are therefore somewhat misdirected. It is also shown that, counter-intuitively, people often judge CF arrangements that yield a low effective hourly rate for the lawyer as more unfair than CF arrangements that yield a high effective hourly rate. The policy implications of these and other findings are discussed in detail.
NEITHER SAINTS NOR DEVILS: A BEHAVIORAL ANALYSIS OF ATTORNEYS’ CONTINGENT FEES

Eyal Zamir and Ilana Ritov*

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* Augusto Levi Professor of Commercial Law, Faculty of Law, Hebrew University of Jerusalem; Professor, School of Education and Center for Rationality, Hebrew University of Jerusalem, respectively. We would like to thank Maya Bar-Hillel, Jonathan Baron, Lester Brickman, Yuval Feldman, Chris Guthrie, Ehud Guttel, Assaf Hamdani, Roy Kreitner, Herbert Kritzer, Daphna Lewinsohn-Zamir, Barak Medina, Ariel Porat, Eric Posner, Doron Teichman and David Weisburd for invaluable comments on earlier drafts. Special thanks are due to Asaf Posner for long discussions of the practicalities of the market for legal services in Israel, and to Shirley Amsterdam, Yoel Ben Or, Efrat Hurvitz, Marina Motsenok, Maya Shaton and Gil Tessler for excellent research assistance. Finally, we are grateful for the financial support of the Milton and Miriam Handler Foundation and the U.S.–Israel Bi-national Science Foundation.
INTRODUCTION

Contingent Fee (CF) arrangements are the standard method of financing civil litigation in several types of suits, including personal injuries, collection of commercial and retail accounts, and class actions. Under such arrangements, the attorney’s fee is contingent on the success of the claim, calculated as a certain percentage of the amount recovered, and paid upon recovery. A clear advantage of CF, in comparison to hourly-based fee and fixed fee (FF) arrangements, is that it enables plaintiffs of limited financial means to secure otherwise unaffordable legal services. It increases access to the courts, thereby empowering the underprivileged and strengthening the legal incentives for people to internalize the costs of their injurious behavior.\(^1\) Nevertheless, the desirability, efficiency and fairness of CF are hotly debated.

Advocates of CF point out that this arrangement provides clients with credit (since the fee is paid only upon recovery) and with a sort of insurance (since the fee is not paid if the claim fails). The CF induces attorneys not to take cases whose expected value is too small, thus saving their clients (and the court system) the costs involved in pursuing such claims. It also incentivizes the attorney to win the case or attain a favorable settlement, and at the same time to avoid investing too much time in handling it (a likely negative effect of hourly fees). Given these additional benefits to the client, it is argued that the effective hourly rate of CF (the expected fee divided by the number of hours the lawyer works on the case) is very reasonable compared to prevailing hourly rates.\(^2\)

Critics of current CF practices discard this rosy picture. They argue that the insurance element of CF is illusory since there is typically no real risk involved in cases attorneys take

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\(^1\) Geoffrey C. Hazard, Jr. & W. William Hodes, The Law of Lawyering § 8.12, at 8-27 – 8-28 (3d ed., 2001, Supp. 2003) (stating that CF provides access to the courts by people who would not otherwise be able to litigate); Richard A. Posner, Economic Analysis of Law 615 (7th ed., 2007) (arguing that, although CF makes it easier for illiquid or risk-averse people to bring suits, it does not necessarily result in more litigation, because “the likelier a suit is to be brought if there is violation of law that causes injury, the greater is the deterrent effect… and hence the less likely are potential defendants to engage in the forbidden conduct”); Neil Rickman, The Economics of Contingency Fees in Personal Injury Litigation, 10 Oxford Rev. Econ. Pol’y 34, 39, 44-47 (1994) (pointing to the distributional and deterrence advantages of enhancing access to justice through CF).

on a CF basis. Similarly, the credit element should not add much to the fee because the attorney enjoys an excellent collection means: she deducts her fee from the award before forwarding it to her client. Current CF rates, so it is charged, reflect various market failures, including plaintiffs’ inability to assess the value and prospects of their case and the scope of work involved in handling it, lawyers’ uniform pricing practices, the absence of price advertisements, clients’ prohibitive search costs, and the prohibitions against the purchase of tort claims and against brokerage of lawyers’ services. Consequently, CF rates are often disproportionately high. Aware that a large share of the award goes to the attorney, courts and juries increase the compensation they grant plaintiffs. The debate is thus closely connected to broader issues, such as the alleged litigation explosion, the calls for a tort reform, lawyers’ ethics, and even (indirectly) defensive medicine and its implications for the American health system.

The CF debate revolves around factual, positive and normative issues. Hundreds of studies have offered conflicting accounts of the market for legal services, competing explanations for the market’s behavior and radically different prescriptions for its regulation. Numerous legal scholars, economists and other social scientists have contributed to this vast body of theoretical and empirical literature. Curiously, no attempt has been made to analyze the issue from the perspective of cognitive psychology. This Article begins to fill this gap. Building on

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3 Lester Brickman, Contingent Fees Without Contingencies: Hamlet Without the Prince of Denmark?, 37 UCLA L. Rev. 29, 31 (1989) (“[C]ontingent fees are charged in a substantial number of retainer agreements, though no real contingency exists”).
5 See, e.g., Lester Brickman, On the Relevance of the Admissibility of Scientific Evidence: Tort System Outcomes Are Principally Determined by Lawyers’ Rates of Return, 15 CARDOZO L. Rev. 1755 (1994) (arguing that expansion in tort liability has largely resulted from attorneys’ efforts to increase their rates of return); Thomas J. Miceli & Kathleen Segerson, Contingent Fees for Lawyers: The Impact on Litigation and Accident Prevention, 20 J. LEGAL STUD. 381 (1991) (analyzing the claim that CF encourages excessive litigation).
8 An exception is Robert E. Thomas, Psychological Impact of Scrutiny on Contingent Fee Attorney Effort, 101 W. VA. L. REV. 327 (1998). Thomas argues that in high profile cases, the attorney’s desire to avoid appearing foolish or being wrong, and the related phenomenon of escalating commitment, may mitigate the attorney’s
past behavioral studies, we conducted a series of experiments designed to reveal people’s preferences regarding attorneys’ fees and their perceptions of the fairness of those fees. Our findings shed new light on various aspects of the debate, including the following questions: How much more people are willing to pay in contingent fees, compared to fixed fees, and why? Do these preferences stem from plaintiffs’ lack of information as to the value of their claims, the attorney’s expected work, or the availability of alternative fee arrangements? Why are CF rates uniform? Why do defendants rarely make recourse to CF? What factors determine people’s perceptions of the fairness of CF arrangements, and how do these perceptions affect the prevailing CF rates and their regulation?

As regards the first question, since the outcomes of the lawyer’s work are uncertain, we suggest to analyze plaintiffs’ choice between CF and non-contingency fees (that is, an hourly or a global, fixed fee) as a choice between two “gambles.” According to rational choice theory (underlying standard economic analysis), the choice between these two gambles depends on each gamble’s expected utility and on the subject’s risk aversion. According to the descriptive theory proposed by Daniel Kahneman and Amos Tversky, known as prospect theory, people’s preferences deviate from the predictions of rational choice theory in systematic ways. First and foremost, people assign value to gains and losses, rather than to final assets or final positions. The value function is defined over changes from a reference point and is normally concave for gains (implying risk aversion), commonly convex for losses (risk seeking) and is generally steeper for losses than for gains (loss aversion). People’s choices therefore crucially depend on the way they frame the choice, and particularly on their reference point, which determines what changes are perceived as gains or losses. Non-contingency fees expose the plaintiff to the risk of losing her case and still having to pay the attorney’s fee. It is therefore a mixed gamble in which the plaintiff may either win some gain, or bear a loss. In contrast, while a CF arrangement may bring about a smaller gain in the case of success, it eliminates the risk of loss, because no fee is paid to the lawyer if the case is lost. It is therefore a pure positive gamble, in which the plaintiff may either gain or break even.
Rational choice theory predicts that the choice between CF and non-contingency fees will significantly depend on the chooser’s risk aversion. Assuming diminishing marginal utility of money, and standard assumptions about the shape of the utility curve, it predicts that the wealthier a person is, the less she would opt for CF, if FF would give her a higher expected net gain (the expected award minus the attorney’s fee). Under prospect theory, no such correlation between people’s affluence and their preference for CF is necessarily predicted. Moreover, under rational choice theory, the premium plaintiffs would be willing to pay to insure against the risk of bearing the legal costs even if their claim fails is not very high, especially if they are well-off. In contrast, prospect theory predicts that if the choice between CF and FF is indeed framed as a choice between a pure positive gamble and a mixed one, people would prefer CF even if the expected fee under CF is two or three times higher than under a non-contingency fee arrangement! This strong preference for CF is independent both of people’s absolute wealth and the ratio between their wealth and the cost of legal services.

To test these predictions, we designed experiments in which subjects were asked to choose between CF and FF under various hypothetical circumstances.\textsuperscript{10} These experiments provide a clear support for the predictions of prospect theory, thus casting doubt on other explanations for prevailing CF rates. As mentioned above, some commentators argue that current CF rates reflect clients’ inability to assess the value of their claim, the risk involved in it, and the amount of work it might require, or that they result from the unavailability of alternative fee arrangements. Since the questions in our experiment provided the subjects with all of this information and allowed them to choose between CF and FF, it does not seem that their strong preference for CF stems primarily from information asymmetry or lack of options. Moreover, we ran the same experiment with tort lawyers who were asked to make the same choice assuming they suffered a loss and needed an attorney to represent them. Their choices were similar to those of lay persons. The pattern of choice was not affected by the presumably significant differences in affluence between students and practicing tort lawyers. Finally, we tested the hypothesis that the preference for CF rests on the incentive effects of CF. To that end, we ran an experiment in which the type of fee paid by the plaintiff (either CF or FF) was decoupled from the type of remuneration paid to the attorney who actually handled the case.

\textsuperscript{10} Controlled laboratory experiments are inferior to empirical studies in terms of their external validity, but superior in terms of their ability to isolate the variables affecting people’s preferences and choices. The external validity of the correlations found in experiments depends on the degree of similarity between the experimental environment and the real world. On the methodology of behavioral research and the use of experimental methodology in law, see generally ROBERT ROSENTHAL & RALPH L. ROSNOW, ESSENTIALS OF BEHAVIORAL RESEARCH: METHODS AND DATA ANALYSIS (3rd ed. 2007); Colin Camerer & Eric Talley, Experimental Study of Law, in \textit{2 HANDBOOK OF LAW AND ECONOMICS} 1619 (A. Mitchell Polinsky & Steven Shavell eds., 2007).
using an intermediary entity. Such decoupling did not significantly alter plaintiffs’ preferences, thus indicating that incentives do not play a prime role in this choice. We conclude, therefore, that prospect theory provides a major descriptive explanation for plaintiffs’ preferences.

Another intriguing aspect of the market for legal services is that unlike plaintiffs, defendants only infrequently hire attorneys on a CF basis. Various economic explanations have been offered for this phenomenon, most of which focus on the different characteristics of the typical plaintiff and defendant. Based on experimental results, we propose a different explanation, grounded, once again, in prospect theory. Specifically, we argue that from the plaintiff’s perspective, the decision is framed as a choice between a pure positive gamble and a mixed one (thus inducing loss aversion), and from the defendant’s point of view as a choice between two pure negative gambles (thus inducing risk seeking). Risk-seeking defendants prefer to assume the risk of having to pay both damages and the lawyer’s fixed fee, rather than to pay, at a minimum, a higher contingent fee if the suit is fully dismissed.

The CF market is further characterized by uniformity of the prevailing rates. Presumably, CF rates should reflect the size of the claim, the prospects of winning it, and the expected amount of work—all of which vary considerably from one case to another. It could thus be expected that, to yield similar effective hourly rates, CF rates should vary considerably, from a very low percentage in cases where the claimed sum and the probability of success are very high, to a very high percentage where the claimed sum and probability of success are low. In fact, however, CF rates are distinctively, though not invariably, uniform. Some commentators attribute this uniformity to a market failure and to the interplay between the plaintiff bar and regulators. In an experiment designed to identify the factors bearing on the perceived fairness of different CF arrangements, we found out that very high CF rates are considered as unfair, even when they result in a low effective hourly rate for the lawyer. While our experiments reveal that this common fairness judgment does not necessarily affect clients’ preferences for (high) CF arrangements, it probably affects both lawyers who care about their reputation and regulators who set caps for CF rates. The resulting “fairness constraint” drives very high CF rates out of the market even in cases where the parties would have found them mutually beneficial.

We propose to account for the distinctive uniformity of CF rates on the basis of such documented phenomena as the roles of focal points and status quo bias in bargaining, and on the fairness constraint. We further suggest that the standard rate endures in the market thanks to a process of assortative matching, that is, the process through which plaintiffs with very
strong cases contract with the very best lawyers, second-best cases are handled by second-best attorneys, and so forth.

In addition to their theoretical interest, our findings are of great practical importance, as proposals to regulate CF are repeatedly considered by legislators throughout the country. For instance, if it is true that plaintiffs’ strong preference for CF does not stem primarily from information problems, then proposals to impose stricter pre-contractual disclosure duties on attorneys are somewhat misdirected. Relatedly, if very high CF rates are deemed unfair even when they result in a rather low effective hourly rate, then the rarity of such rates does not necessarily point to a market failure. In the same vein, if the uniformity of CF rates is due to such phenomena as focal points, status quo bias and assortative matching, then this uniformity does not necessarily indicate any market failure and thus does not warrant, in and of itself, any regulation. Finally, the fact that the strong preference for CF is unrelated to a plaintiff’s affluence is a relevant factor in considering the distributive effects of CF and its regulation.

Our findings may have positive and normative implications for other spheres in which people face a choice between a pure positive gamble and a mixed one. People encounter such choices, for example, in financial markets. If people have strong preferences for pure positive gambles, then to the extent that similar choices may be framed differently, financial institutions can use this phenomenon to induce investors to opt for poorer investments by framing them as pure positive gambles.

The Article proceeds as follows. Part I examines people’s preferences in the choice between contingent and non-contingent fees. It opens with a brief review of the ongoing debate on whether CF rates are excessively high and whether the market for legal services is competitive (Section I.A). Section I.B provides a theoretical and comparative background to the experiments. Subsection I.B.1 sets the theoretical background for our argument concerning plaintiffs’ strong preference for CF by briefly presenting Tversky and Kahneman’s prospect theory. Since we conducted the experiments in Israel, Subsection I.B.2 briefly compares CF in Israel and the United States. Section I.C describes the findings of three experiments we designed to better understand why plaintiffs prefer CF and why CF rates may be high. Finally, Section I.D analyzes the experimental results and discusses their theoretical and normative implications.

Part II discusses people’s perceptions of the fairness of CF rates and their possible effect on the market. Section II.A surveys different notions of perceived fairness and their relevance to CF arrangements. Section II.B then describes an experiment in which we examined which factors affect people’s judgments of the fairness of CF arrangements and to what extent. Specifically, we directly examined how these judgments are affected by the size of the expected recovery, the probability of recovery and the CF rate, and indirectly how they are affected by the lawyer’s effective hourly rate. Section II.C discusses our findings and examines their implications.

Part III addresses the puzzling phenomena of the distinctive uniformity of CF rates in the market. Section III.A reviews the evidence for the existence of such uniformity and the attempts made to account for it. Section III.B proposes alternative explanations for this reality, focusing on the role of focal points in bargaining, the causes for people’s reluctance to deviate from trade usages, and the process of assortative matching. It then refers to the policy implication of this analysis.

While the first three parts of the article discuss different aspects of the prevalent use of CF arrangements by plaintiffs, Part IV turns to the defendants’ side. Part IV.A grapples with the plaintiffs/defendants puzzle and critically surveys existing attempts to explain why it is that predominantly plaintiffs use CF. Section IV.B describes an experiment designed to study people’s choices of fee arrangements as plaintiffs and as defendants. Section IV.C analyzes the results and implications of the experiment. A conclusion follows.

I. Why and How Much Do Plaintiffs Prefer Contingent Fees?

A. The Debate

In the United States, the conventional flat CF rate is 33% of the recovery. When the rate depends on the stage to which the case arrives, it is usually 25% if the case does not go to trial, rising to as high as 50% if the case reaches the appellate court. While there is a relatively broad consensus about this typical range of fees, there is disagreement regarding the ratio between ordinary hourly rates charged by lawyers and the effective hourly rates resulting from CF arrangements. Since CF provides the client with a kind of insurance and credit, it stands to reason that in a competitive market, the effective hourly rate of CF should be somewhat higher than the rate charged under non-contingent arrangements, such as hourly fee
or FF arrangements. However, while some researchers maintain that the effective hourly rates of lawyers resulting from conventional CF are only slightly (and justifiably) higher than standard non-contingency hourly rates,\(^{13}\) others claim that CF arrangements often result in effective rates that are several times higher than ordinary hourly rates.\(^{14}\) In this context, it is argued that the risk of failure borne by CF lawyers is rather low because they carefully select the cases they take.\(^{15}\) Others reply that in addition to the risk of complete non-recovery, CF must reflect the more common risks of low recovery and of spending unexpectedly large amount of time on the case.\(^{16}\) Comparable controversies surround the element of credit, as it is argued that thanks to the simple and effective means of collection—deducting the fee from the award before forwarding it to the plaintiff—it should not add much to the fee.\(^{17}\)

We do not have much to add to this basically empirical debate, and thus we shall neither elaborate on it nor try to resolve it. Rather, following most of the literature, we shall assume that the effective hourly rate under CF is indeed significantly (or at least not insignificantly) higher than under non-contingency fee arrangements, and that this difference cannot be entirely attributed to the insurance and credit elements of CF.\(^{18}\) Even Kritzer’s empirical study—which was severely criticized by CF opponents—while estimating that the *median* effective hourly fee resulting from CF in early 1990’s Wisconsin ($132) was only marginally higher than ordinary hourly fees ($124), found that the *mean* effective hourly fee ($242) was

\(^{13}\) See references in *supra* note 2 and further details below.


\(^{15}\) See Brickman, *supra* note 4, at 79-80 (explaining that lawyers do not randomly select the cases they take, but rather reject claims with a low likelihood of success or low anticipated return); Brickman, *supra* note 3, at 92 (“Contingent fees are routinely charged in the absence of risk”). See also Kritzer, *Risks, supra* note 2, at 67-89 (discussing data indicating that CF lawyers reject most of the cases offered to them).

\(^{16}\) See Brickman, *supra* note 4, at 17-19 (arguing that in most cases, the real contingencies are not whether there will be a recovery, but rather what would the amount recovered be, how much time and effort would be required to obtain the recovery, and how much time will pass before it is obtained).

\(^{17}\) See Brickman, *supra* note 3, at 118-19 (arguing that, unlike the interest charged by banks, the interest component of CF should contain no element of risk, and thus a reasonable rate would be the statutory rate for prejudgment interest. Note that the interest does not refer to the entire recovery, but to the lawyer’s fee only).

\(^{18}\) See, e.g., Brickman, *supra* note 4; Leonard Gross, *Are Differences among the Attorney Conflict of Interest Rules Consistent with Principles of Behavioral Economics?*, 19 GEO. J. LEGAL ETHICS 111, 138 (2006) (“Personal injury lawyers realize that they can make much more money per hour by handling cases on a contingent fee basis”); Koniak, *supra* note 14, at 352. See also Thomas B. Metzloff, *Resolving Malpractice Disputes: Imaging the Jury’s Shadow*, 54 LAW & CONTEMP. PROBS. 43, 100-101 (1991) (arguing that in damages-only cases, that is cases in which liability is not seriously disputed, “a contingency fee agreement awarding 33 percent or more of the total recovery would, in most instances, be grossly out of proportion to the effort required and the costs incurred”).
almost twice as large as the ordinary hourly fee. Based on this data and on data regarding federal cases, Kritzer points out that the large gap between the mean and median effective rates comes from the top 10% of cases that produce the largest profits for CF lawyers. He estimates that, excluding those 10%, an attorney may expect a fee premium of 25% to 30% compared to what hourly rates generate. The premium is much higher once we take into account all cases, including the most profitable ones.

Two additional explanations (beside the insurance and credit elements of CF) have been offered for this difference. One common explanation rests on standard market failure analysis. It asserts that although there are many lawyers willing to represent tort and other claimants, the market is not competitive due to clients’ acute information problems (regarding the expected reward, the risk involved in the suit, the quality of legal services provided, the time required to handle the case, etc.), and various means devised by lawyers to inhibit competition in this sphere.

An alternative explanation does not rest on any market failure, but rather on the dual function of any fee arrangement: rewarding the attorney for her time and efforts, and creating an optimal incentive for the use of her time and skill. If a lawyer is paid for her time regardless of the outcomes of her services, she may file a legal suit even when it is not in the best interest of the client, spend too much time on the case, and reject attractive settlement offers. To create perfect incentives for the lawyer in all of these regards, lawyers should presumably be allowed to purchase the client’s cause of action for a fixed sum. If the lawyer receives the entire recovery, she has no reason to spend too much or too little effort in

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19 See Kritzer, Seven Myths, supra note 2, at 761-68. For a critique of Kritzer’s findings and conclusions, see Brickman, supra note 14. For a rejoinder, see Kritzer, supra note 14.

20 Kritzer, Risks, supra note 2, at 218.

21 For additional data analyses, see Kritzer, Wages of risk, supra note 2.

22 Brickman, supra note 4, at 76-105 (arguing that the market for CF-financed tort litigation is not competitive for those reasons); Gross, supra note 18, at 136-40; Rickman, supra note 1, at 41-42 (critically discussing the argument that CF rates are excessive due to market failures). Cf. Richard W. Painter, Litigating on a Contingency: A Monopoly of Champions or a Market for Champerty?, 71 CHI.-KENT L. REV. 625, 653-68 (1995) (discussing additional market imperfections allegedly characterizing the CF market, including the tie-in of different products—legal services, credit, and insurance—and price discrimination).

23 Kevin M. Clermont & John D. Currivan, Improving On the Contingent Fee, 63 CORNELL L. REV. 529, 534-43 (1978) (presenting an economic model establishing these claims); Eric Helland & Alexander Tabarrok (2003), Contingency Fees, Settlement Delay and Low-Quality Litigation: Empirical Evidence from Two Datasets, 19 J. L. ECON. & ORG. 517 (2003) (analyzing empirical evidence that hourly fees encourage the filling of low-quality suits and increase the time to settlement while contingency fees have the opposite effects).

24 See, e.g., Rickman, supra note 1, at 36-38. More precisely, the fraction of the cost of litigation borne by the lawyer should equal the fraction of the award or settlement that she obtains. See A. Mitchell Polinsky & Daniel L. Rubinfeld, Aligning the Interests of Lawyers and Clients, 5 AM. L. & ECON. REV. 165 (2003) (suggesting a three-party arrangement that would achieve such alignment of interests). Cf. Robert D. Cooter & Ariel Porat, Anti-Insurance, 31 J. LEGAL STUD. 203 (2002) (suggesting a general mechanism to achieve proper incentives when multiple parties are involved).
handling the case. However, such arrangements are deemed unethical and illegal, and in any case would raise serious practical problems of their own. Standard CF does not perfectly align the attorney’s interests with those of the client, as it induces the attorney to accept settlement offers that are not necessarily in the client’s best interest; yet, the higher the lawyer’s share of the recovery (through CF), the more their interests converge. Clients who wish to maximize their expected net recovery should therefore agree to a CF that is higher than the one reflecting the competitive zero-profit rate, thus creating economic rents for attorneys. The client’s expected gain from strengthening the lawyer’s motivation outweighs the expected loss from the larger share paid to the lawyer.

While both of these explanations sound reasonable, and the latter was even supported by a laboratory experiment, they are also subject to critique. It is not, however, our goal to evaluate these explanations in detail. Rather, we strive to enrich the discussion by offering an additional explanation—or rather set of explanations—to why clients agree to pay high CF. Before turning to describe our own experiments, the next Section provides a brief theoretical background on the pertinent behavioral theory and a short account of CF in Israel, where our experiments were conducted.

26 Clermont & Currivan, supra note 23, at 596.
28 Rudy Santore & Alan D. Viard, Legal Fee Restrictions, Moral Hazard, and Attorney Rents, 44 J. L. & ECON. 549 (2001); Bruce L. Hay, Contingent Fees and Agency Costs, 25 J. LEGAL STUD. 503 (1996) (arguing that the optimal CF for the client is the one that minimizes two agency costs: underinvestment in the claim and attorney rents).
29 Michael McKee, Rudy Santore & Joel Shelton, Contingency Fees, Moral Hazard, and Attorney Rents: A Laboratory Experiment, 36 J. LEGAL STUD. 253 (2007).
30 For instance, these explanations tend to downplay lawyers’ non-selfish motivations, the importance of reputation, and clients’ ability to know whether the attorney spends appropriate time and effort on their case (KRITZER, JUSTICE BROKER, supra note 2, at 108-11). Furthermore, an empirical study of the amount of time lawyers spend on cases taken on different fee bases revealed a much more nuanced picture than what abstract economic models predict (Id., at 111-34). On the role of reputation, see also KRITZER, RISKS, supra note 2, at 219-252.
B. THEORETICAL AND COMPARATIVE BACKGROUND

1. Rational Choice Theory v. Prospect Theory

Standard economic analysis, including economic analysis of law, is based on the rational choice theory of human behavior.\(^{31}\) According to this theory, from among the available options, people choose the one that maximizes their expected utility. People’s preferences and choices are assumed to be rational in the sense that they comply with several basic axioms, such as completeness, transitivity, invariance and dominance.\(^{32}\) People are assumed to consider all available, relevant information, ignore any irrelevant information, and make correct use of the rules of probability. In addition to these characteristics of cognitive, or \textit{thin}, rationality, rational choice theory also makes certain assumptions about people’s motivation (\textit{thick} rationality). It posits that people are maximizers of their own utility.\(^{33}\)

Finally, standard rational choice theory makes important assumptions regarding people’s attitude to risk. According to the \textit{law of diminishing marginal utility}, the utility one derives from any additional unit of a good or service, including money, is smaller than the utility she derives from the previous unit. A person would therefore prefer a sure loss of $200 to a 10\% chance of losing $2,000, and the latter to a 1\% chance of losing $20,000. While risk aversion depends on personal inclinations, it is assumed that as a general rule, the concavity of people’s utility curve is decreasing, and thus the wealthier the individual, the smaller her risk-aversion. For instance, a 10\% chance of losing $10,000 is much more significant for a person whose entire fortune is $40,000 than for a person whose fortune is $250,000.\(^{34}\)

In 1979, Daniel Kahneman and Amos Tversky proposed a competing, descriptive theory of people’s preferences and choices under risk, the prospect theory.\(^{35}\) This theory comprises of several elements, all of which violate the axioms of rational choice theory. First


\(^{32}\) Completeness of preferences means that for any two alternatives A and B, any person prefers A to B, B to A, or is indifferent between the two. Transitivity means that if a person prefers A to B and B to C, she necessarily prefers A to C. Invariance requires that choices are not affected by the way the various alternatives are presented to the decisionmaker. Dominance posits that if a person prefers A to B in a certain situation or in a certain respect, and evaluates A as not less attractive than B in all other situations and respects, then she would necessarily choose A.


\(^{34}\) On risk aversion see generally STEVEN SHAVELL, \textit{Economic Analysis of Accident Law} 186-205 (1987).

\(^{35}\) See Kahneman & Tversky, supra note 9; Tversky & Kahneman, supra note 9; \textit{CHOICES, VALUES, AND FRAMES} (Daniel Kahneman & Amos Tversky, eds. 2000) (a collection of seminal works on prospect theory).
and foremost, prospect theory posits that people ordinarily perceive outcomes as gains and losses, rather than as final states of wealth or welfare. Gains and losses are defined relative to some reference point. The value function is normally concave for gains (implying risk aversion), commonly convex for losses (reflecting risk seeking) and is generally steeper for losses than for gains (indicating loss aversion). People’s choices therefore crucially depend on the way they frame any choice. In particular, people’s reference point determines what changes are perceived as gains or losses. Ordinarily—but not invariably—people take the status quo as their reference point. Prospect theory also posits that people’s risk aversion in the domain of gains and risk seeking in the domain of losses are reversed for low probability gains and losses. Another component of prospect theory concerns the subjective weighing of probabilities. The latter issues will not be addressed here.

In the years following the publication of the prospect theory, research was conducted on loss aversion which yielded seminal studies of its role in diverse economic phenomena. The theory explains not only naïve preferences and choices, but also judgments and decisions made by sophisticated, professional actors; yet some studies argue that experienced decision

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36 The subjective value function proposed by prospect theory has the following form: \( v(x) = x^\alpha \) if \( x \geq 0 \); \(-\lambda(-x)^\beta \) if \( x < 0 \). The modeling of value in prospect theory allows for the non-linearity of the value function around the reference point. Including the parameters \( \alpha \) and \( \beta \), which are typically smaller than 1, yields the concavity and convexity of the value function in the domains of gains and losses, respectively. The parameter \( \lambda \) is referred to as the coefficient of loss aversion. \( \lambda \) greater than one implies that the same absolute difference in value will be weighted more heavily when it is in the loss domain than when it is in the gains domain. Kahneman and Tversky estimated \( \alpha \) and \( \beta \) to be 0.88 and \( \lambda \) to be 2.25.

37 See Amos Tversky & Daniel Kahneman, Loss Aversion in Riskless Choice: A Reference-Dependent Model, 106 Q.J. ECON. 1039, 1046-47 (1991) (stating that “the reference state usually corresponds to the decision maker’s current position,” but that “it can be influenced by aspirations, expectations, norms, and social comparisons”). For a model taking people’s expectations, and not necessarily the status quo, as the pertinent reference point, see Botond Köszegi & Matthew Rabin, A Model of Reference-Dependent Preferences, 121 Q. J. ECON.1133 (2006).

38 Tversky & Kahneman, supra note 9, at 306 (describing a “fourfold pattern of risk attitudes”). This reversal of attitude to risk can explain the buying of lottery tickets on the one hand and the purchase of insurance on the other hand. For a legal application of this element of prospect theory, see Guthrie, supra note 8 (analyzing frivolous litigation).

39 These include the endowment effect (see, e.g., Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, Experimental Tests of the Endowment Effect and the Coase Theorem, 98 J. POLITICAL ECON. 1325 (1990); see also infra notes 132-137 and accompanying text), the status-quo bias (see, e.g., William Samuelson & Richard Zeckhauser, Status Quo Bias in Decision Making, 1 J. RISK & UNCERTAINTY 7 (1988)), the equity premium puzzle (see, e.g., Shlomo Benartzi & Richard H. Thaler, Myopic Loss Aversion and the Equity Premium Puzzle, 110 Q. J. ECON. 73 (1995)), the tendency to hold on to losing investment (Barry M. Staw, The Escalation of Commitment to a Course of Action, 6 ACAD. MANAGEMENT REV. 577 (1981)), and the difficulty of reaching an agreement in negotiations involving losses (Margaret A. Neale & Max H. Bazerman, The Effects of Framing and Negotiator Overconfidence on Bargaining Behaviors and Outcomes, 28 ACAD. MANAGEMENT J. 34 (1985); Max H. Bazerman et al., Negotiation, 51 ANN. REV. PSYCH. 279 (2000)). See also CHOICES, VALUES, AND FRAMES, supra note 35 (a collection of studies); Rachlinski, supra note 8, at 124 (referring to numerous studies of framing effects).

40 See, e.g., Joshua D. Coval & Tyler Shumway, Do Behavioral Biases Affect Prices?, 40 J. FINANCE 1 (2005) (finding that Chicago Board of Trade proprietary traders display high loss aversion, regularly assuming above-average afternoon risk to recover from morning losses); Robert A. Olsen, Prospect Theory as an Explanation of
makers can overcome the endowment effect and other manifestations of prospect theory.\textsuperscript{41} In addition to the strong experimental evidence, prospect theory has been supported by various empirical studies of different spheres of human activity.\textsuperscript{42}

Although prospect theory speaks directly to preferences among options that vary in gains and losses, little research addressed the choice between mixed gambles (involving both gains and losses). Even less research examined preference between mixed gambles and pure positive ones. A notable exception is the work of John Payne and his colleagues, who investigated preference among gamble pairs with equal expected value.\textsuperscript{43} In their experiments, subjects were asked to choose between pairs of gambles whose expected value was identical, but in which the differences between the best and worst outcomes in each gamble were different. Then, a constant sum was added to or subtracted from all outcomes of both gambles in each pair, thus transforming gamble pairs that were pure positive gambles into pairs including one pure positive and one mixed gamble. This transformation yielded systematic preference reversals: the gamble that remained purely positive after the transformation was clearly preferred to the gamble that became a mixed one as a result of the transformation.\textsuperscript{44}

Thus, at least in cases of equal expected value gambles, one can infer from this study a preference for pure positive gambles over mixed ones. A more recent study yielded similar finding, showing that when choosing between multiple-outcome gambles, people prefer those gambles with fewer negative outcomes.\textsuperscript{45}

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{41}] See, e.g., John A. List, Neoclassical Theory vs. Prospect Theory: Evidence From the Marketplace, 72 ECONOMETRICA 615 (2004) (finding that contrary to inexperienced consumers, people with intense market experience behave largely in accordance with neoclassical predictions, rather than according to the predictions of prospect theory); Lei Feng & Mark S. Seasholes, Do Investors Sophistication and Trading Experience Eliminate Behavioral Biases in Financial Markets?, 9 REV. FINANCE 305 (2005) (finding that sophistication and trading experience eliminate the reluctance to realize losses).
\item[\textsuperscript{42}] See Colin F. Camerer, Prospect Theory in the Wild: Evidence from the Field, in CHOICES, VALUES, AND FRAMES, supra note 35, at 288.
\item[\textsuperscript{44}] For instance, when choosing between one gamble that offers 60% chance of winning 30, 30% chance of losing 60, and 10% chance of neither winning nor losing and another gamble that offers 50% chance of winning 8, 20% chance of losing 20, and 30% chance of neither winning nor losing, most people prefer the first gamble. However, if 25 is added to all outcomes of both gambles (thus keeping the expected value of the two gambles equal), the second gamble becomes a pure-gain gamble: its worse outcome is a gain of 5. In that case, Payne and his colleagues found that most people prefer the second gamble over the first.
\item[\textsuperscript{45}] Michael H. Birnbaum, Evidence Against Prospect Theories in Gambles with Positive, Negative, and Mixed Consequences, 27 J. ECON. PSYCH. 737 (2006).
\end{itemize}
\end{footnotesize}
2. Contingent Fees: A Comparative Account

Since the experiments described below were conducted in Israel, it seems useful to briefly describe the relevant Israeli legal and market environment.\(^{46}\) CF arrangements are as prevalent in Israel as they are in the United States, and are regularly used in the same areas of law where they are used in the United States. CF rates are only regulated in specific spheres, primarily in the sphere of death and personal injuries caused by road accidents, where a system of strict liability and a compulsory insurance was established in the mid-70’s.\(^{47}\) Proposals to regulate CF in other areas are occasionally debated.\(^{48}\) CF rates in Israel are almost as uniform as they are in the United States. The standard, flat rate in tort actions (excluding road accidents) is 20-25% of the recovery.\(^{49}\) Sliding scales are sometimes used, whereby the CF rate if no suit is filed is 15% of the recovery, if a settlement is reached after filing a suit but before the case is tried – 17.5%, and otherwise – 20%.\(^{50}\)

We conjecture that two major reasons account for the lower rates of CF in Israel as compared to the United States. First, Israeli lawyers are ethically prohibited from financing the plaintiff’s out-of-pocket expenses, such as court fees and expert witnesses fees.\(^{51}\) American lawyers ordinarily bear these costs, at least in personal injury claims, and implicitly charge their clients for this service. Even if the plaintiff prevails and the attorney is reimbursed for these expenses, she is expected to be remunerated for the credit she has

\(^{46}\) Contingent fees were traditionally prohibited and are still considered illegal or unethical in most legal systems. The prohibition is, however, gradually eroding in many countries. For a comparative view of CF and comparable arrangements, see, e.g., Kritzer, Risks, supra note 2, at 256-59; W. Kent Davis, The International View of Attorney Fees in Civil Suits: Why Is the United States the “Odd Man Out” in How It Pays Its Lawyers, 16 ARIZ. J. INT’L & COMP. L. 361, 371-99 (1999). See also Adrian ZuckerMan, ZuckerMan on Civil Procedure: Principles of Practice (2d ed. 2006) 1053-79 (analyzing recent developments in English law).

\(^{47}\) See Road Accident Victims Compensation Law, 1975, 29 L.S.I. 311; Bar Association Rules (Maximum Fee for the Handling of Claims under the Road Accident Victims Compensation Law), 1977, K.T. p. 1358 (The maximal rates are 8% of the recovery if the claim is settled without filing a suit, 11% if a suit is filed and then a settlement is reached, and 13% of the award if the case is adjudicated and a judgment is rendered by the court). Another, very specific context in which CF rates are regulated is claims by holocaust survivors. See sec. 10 of the Claims by Victims of the Nazis or their Satellites (Regulation of Handling) Law, 1957, 11 L.S.I. 70; Claims by Victims of the Nazis or their Satellites (Regulation of Handling) Regulations, 1965, K.T. p. 1800 (setting varying maximal rates for different services, most of which are in the range of 8% to 12% of the awarded sums). For further details, see Gabriel Kling, Ethics for Lawyers 243-58 (2001, in Hebrew).


\(^{49}\) Yair Ben-David, The Lawyer and His Client 167 (1999, in Hebrew). According to our survey, which yielded 58 responses from tort lawyers, the common CF rate (excluding road accidents) is 20%.

\(^{50}\) Id.; Kling, supra note 47, at 249 (referring to personal injury claims).

provided her client and the risk of not getting this reimbursement. Since Israeli lawyers are not allowed to provide their clients with this benefit, they do not charge for it.

The second reason for the difference in CF rates is that in Israel—following the “English Rule” and contrary to the “American Rule”—the losing party ordinarily reimburses the winning party for the attorney’s fee and other expenses. This difference implies, first, that the effective CF in Israel is often higher than it initially seems to be. Under a common arrangement, CF is calculated on the entire sum awarded by the court, including the lawyer’s fee. For instance, if CF is 20% or 25%, and the court awards the plaintiff, in addition to damages of $100,000, a reimbursement of lawyer’s fee of $20,000, under this arrangement the CF is calculated as 20% or 25% of $120,000—that is, $24,000 or $30,000—which is effectively 24% or 30% of $100,000. Another implication of the Israeli rule is that even a CF arrangement does not guarantee an Israeli plaintiff that in case of failure she will break even. A losing plaintiff is likely to bear at least some of the defendant’s costs. At any rate, in our experiments the subjects were explicitly asked to assume that the attorney will bear the entire costs of handling the case, whether it will require filing a suit or not. This assumption both simplified the questions and made them compatible with the American legal environment.

A final comparative remark to be made regarding the two legal systems is that, contrary to the American legal system, in Israel there is no jury system. While this fact decreases the likelihood of mega-judgments in personal injury cases and thus reduces the intensity of the debate surrounding CF arrangements, it does not alter the basic elements of the CF debate. As in the United States, legal liability in general and tort liability in particular has significantly and steadily been expanded over the past few decades.

Against this backdrop, we shall now describe the first set of experiments we conducted to study people’s preferences regarding payment arrangements for legal services.

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53 Although this common arrangement is somewhat controversial (see KLING, supra note 47, at 240) and the default rule is possibly that CF is calculated with regard to the damages only, our understanding of the common practice—based on interviews with tort lawyers—is that lawyers ordinarily contract around this default.
54 Inasmuch as the choice of fee arrangement is made separately from other related decisions (such as the choice of lawyer and the decision whether to pursue the case), it may still be that in choosing between CF and FF, plaintiffs disregard the rule concerning costs reimbursement, which applies irrespective of the fee arrangement. In that case, the added assumption that the lawyer bears all the costs involved in handling the case would not detract from the validity and relevance of our findings to the Israeli legal environment.
C. Plaintiffs’ Choice: Experimental Results

This Section describes in some detail three experiments conducted in 2007 with a view to better understand when and why plaintiffs prefer CF, and why CF rates may be high.

1. Experiment 1: Laypersons and Lawyers

The first experiment was designed to examine whether preference for CF will prevail when the expected payment under a CF arrangement is substantially higher than the FF. In this experiment the expected value of the CF was set to be over three times as much as the FF. We also tested the effect of experience on this preference. Two samples of subjects were used: a sample of naïve subjects consisting of university applicants, undergraduate students and Master students at the Hebrew University of Jerusalem, who do not study law, and a sample of tort lawyers. Finally, we examined whether the choice between CF and FF depends on the type of damage for which recovery is sought. We employed cases in which the plaintiff suffered either property damage or physical injury.

Participants. The naïve sample was comprised of 77 students and university applicants (47 females, 30 males) who responded to the questionnaire in exchange for 10 NIS. Their ages ranged between 18 and 43, with a mean of 24. The expert sample consisted of 66 tort lawyers (29 females, 37 males) who filled out the questionnaire voluntarily. They received and returned it either by mail or filled it out during a medical course offered to lawyers as part of their continuing professional education. Ages ranged from 25 to 74, with a mean of 44; experience as a lawyer ranged from half a year to 43 years, with a mean of 15. The lawyer respondents estimated that an average of 78% of their entire professional activity is dedicated to civil litigation, including cases that do not go to court (the maximum being 100% and the median 82.5%). In about 70% of their civil litigation activity, these lawyers represented plaintiffs rather than defendants. The lawyers indicated that in 90% of the cases in which they represent plaintiffs, they charge on a CF basis (the maximum being 100% and the median 95%). While in personal injuries this percentage rose to 96%, in property damage claims it dropped to 78%. Only 30% of the lawyers had ever represented a defendant on a CF basis.

56 One New Israeli Shekel roughly equals $0.25.
**Experimental Design.** We employed six decision problems for which respondents were asked to indicate whether they preferred the CF or the FF arrangement. They were also given the option to avoid taking any legal action. The numerical details for the six problems are presented in Table 1. These varied in the expected award, the probability of winning, and the proportion of the lawyer’s contingent fee out of the total award. For all problems, the Expected Contingent Fee, ECF (that is, the award \times probability of winning \times percentage of the contingent fee) was set to be more than three times higher than the FF. More precisely, the ratio between FF and ECF ranged from 1:3.21 to 1:3.39, averaging 1:3.3. Each decision problem was presented to half of the subjects as a case of property damage, and to the other half as a case of physical injury. Within each questionnaire, half of the problems were presented as damage to property cases and the other half as physical injury ones. The depiction of the problem as a property damage/physical injury case, as well as the order of the problems and the order of the CF and FF options were counterbalanced across subjects. The tort lawyers were specifically requested to answer how they would act as a client seeking the services of a lawyer, assuming they would not handle the case by themselves. No time constraints on filling the questionnaires were imposed.

<table>
<thead>
<tr>
<th>Case</th>
<th>Award</th>
<th>Prob.</th>
<th>%CF</th>
<th>EV</th>
<th>ECF</th>
<th>ECF/3</th>
<th>FF</th>
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<td>50</td>
<td>47,500</td>
<td>23,750</td>
<td>7,920</td>
<td>7,000</td>
</tr>
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<td>4</td>
<td>55,000</td>
<td>.45</td>
<td>60</td>
<td>24,750</td>
<td>14,850</td>
<td>4,950</td>
<td>4,500</td>
</tr>
<tr>
<td>5</td>
<td>100,000</td>
<td>.90</td>
<td>25</td>
<td>90,000</td>
<td>22,500</td>
<td>7,500</td>
<td>7,000</td>
</tr>
<tr>
<td>6</td>
<td>90,000</td>
<td>.85</td>
<td>30</td>
<td>76,500</td>
<td>22,950</td>
<td>7,650</td>
<td>7,000</td>
</tr>
</tbody>
</table>

57 Hourly fees are more prevalent than global, fixed fees. We nevertheless asked respondents to choose between CF and FF because making the choice between CF and hourly fee would have made the task more complicated, as the amount of hours is typically uncertain ex ante. Fixed fees may be inferior to hourly fees in terms of the lawyer’s incentives to invest in the case. However, to the extent that clients are risk averse, FF is more attractive than hourly fee. Thus, one can confidently assume that in reality, the preference for CF over hourly rates would be at least as large as the preference for CF over FF.

58 Some of the problems are less realistic than others, yet we wished to examine a relatively wide variety of combinations of the three variables.

59 All sums in this and in the following tables are in NIS. EV, the Expected Value of the claim, equals the award multiplied by the probability of getting it. ECF, the Expected Contingency Fee, is the sum the attorney is expected to be paid, calculated by multiplying EV by the percentage of CF.
A typical question read as follows (with the complementary depiction in square brackets):  

Imagine that you were injured in an accident and broke your leg [Imagine that someone broke your computer]. A jurist friend estimates that you may claim damages from the injurer, and that the sum that may be reasonably expected is 90,000 NIS. However, getting the damages is not guaranteed, as the injurer may deny his responsibility, in which case a legal process would be necessary. Your friend estimates that there is a 85% chance of getting the damages.  

You may choose one of the following three options:  

A. Ask a lawyer to represent you in claiming the damages for 30% of the sum received following his handling of the case (if the damages are obtained, the lawyer will get 27,000 NIS, and if no damages are obtained, the lawyer will get nothing). Assume that the lawyer bears all of the costs involved in handling the case.  

B. Ask a lawyer to represent you in claiming the damages for a fixed sum of 7,000 NIS (to be paid even if you’ll get no damages at all). Assume that the lawyer bears all of the costs involved in handling the case.  

C. Avoid handling the matter.  

What option would you prefer? (Circle the appropriate answer) A   B   C  

Results. The percents of CF and FF choices for each case are presented in Tables 2 and 3 for naïve subjects and lawyers respectively. We computed for each subject the percent of CF choices out of all choices (excluding the avoidance choices) separately for the personal injury cases and the property damage cases. Naïve subjects preferred the CF arrangement in 42% of the property damage cases and in 47% of the personal injury ones. The corresponding percents for tort lawyers were 39% and 46% respectively. A repeated measure ANOVA (Analysis of Variance) of the two percentages by sample ( naïve/expert) yielded no significant  

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60 Different descriptions of the property damage and physical injury were used to match the varying magnitudes of expected damages.  

61 To keep the questions simple, we did not refer to the possibility of obtaining different amounts of damages in different probabilities. Even if this gap leaves some ambiguity in the description, since this ambiguity is common to all cases, it should not affect the results.
effect of sample, nor an interaction of the sample with the type of case. Across both samples
the type of case was marginally statistically significant.\textsuperscript{62}

Table 2
Naïve Subjects, N=77, Percent of CF and FF preference, across subjects in each cell.\textsuperscript{63}

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal injury</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CF</td>
<td>52.5</td>
<td>40.5</td>
<td>20.0</td>
<td>59.5</td>
<td>37.5</td>
<td>56.8</td>
</tr>
<tr>
<td>FF</td>
<td>42.5</td>
<td>56.8</td>
<td>77.5</td>
<td>29.7</td>
<td>62.5</td>
<td>40.5</td>
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<tr>
<td>Property Damage</td>
<td></td>
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<td></td>
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<tr>
<td>CF</td>
<td>40.5</td>
<td>27.5</td>
<td>29.7</td>
<td>50.0</td>
<td>35.1</td>
<td>42.5</td>
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<tr>
<td>FF</td>
<td>48.7</td>
<td>70.0</td>
<td>70.3</td>
<td>47.5</td>
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<tr>
<td>Overall</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CF</td>
<td>46.8</td>
<td>33.8</td>
<td>24.7</td>
<td>54.6</td>
<td>36.9</td>
<td>49.4</td>
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<tr>
<td>FF</td>
<td>45.5</td>
<td>63.6</td>
<td>74.0</td>
<td>39</td>
<td>63.6</td>
<td>48.1</td>
</tr>
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</table>

Table 3
Tort lawyers, N=66, Percent of CF and FF preference, across subjects in each cell.

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
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<th>4</th>
<th>5</th>
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<td>Personal injury</td>
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</tr>
<tr>
<td>CF</td>
<td>46.7</td>
<td>44.4</td>
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<td>43.3</td>
<td>64.7</td>
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<tr>
<td>FF</td>
<td>46.7</td>
<td>47.2</td>
<td>72.4</td>
<td>51.4</td>
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<tr>
<td>Property Damage</td>
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</tr>
<tr>
<td>CF</td>
<td>33.3</td>
<td>23.3</td>
<td>31.4</td>
<td>26.7</td>
<td>69.4</td>
<td>37.9</td>
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<tr>
<td>FF</td>
<td>57.6</td>
<td>73.3</td>
<td>60.0</td>
<td>70.0</td>
<td>30.6</td>
<td>62.1</td>
</tr>
<tr>
<td>Overall</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CF</td>
<td>39.7</td>
<td>34.8</td>
<td>26.6</td>
<td>33.8</td>
<td>57.6</td>
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<td>65.6</td>
<td>60.0</td>
<td>42.4</td>
<td>47.6</td>
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</tbody>
</table>

In sum, although the expected payment under the CF arrangement was over three times
higher than the FF, subjects preferred the CF over the FF arrangement in 43\% of the choices,
across the two samples and two types of cases. Preference for CF did not depend upon the
expertise of the responders, and was only slightly and marginally higher for personal injury
cases than for property damage ones.

\textsuperscript{62} F(1,141)=3.443, p=.066. The marginal significance of the effect of the type of case (personal injury/property
damage) does not appear to stem from lack of attention. The six cases were significantly different from each
other (F(5,650)=5.503, p<.001, in a repeated measure ANOVA with the six cases as within-subject dependent
measures).

\textsuperscript{63} The numbers in Tables 2 and 3 do not add up to 100 because of the third option, namely to abstain from taking
any legal measures.
2. Experiment 2: Determinants of Preferences

The purpose of the present experiment was threefold. First, we intended to replicate the results of Experiment 1 with a somewhat lower ratio of expected CF to FF, setting the expected value of CF to be 2.5 times greater than FF. Second, we sought to explore the separate roles of award, probability of success, and rate of CF as determinants of preference for CF. Finally, since this experiment was also designed to examine the correlation between subjects’ choices and the perceptions of the fairness of different CF arrangements (studied separately in Experiment 4, presented in Section II.B below), in addition to the information provided in Experiment 1, subjects were also informed of the number of work hours the case is expected to require.

Participants. 43 students (15 men, 27 women, 1 did not indicate gender) participated in the study in exchange for 5 NIS. Their ages ranged from 19 to 53, with a mean of 25.

Experimental Design. We employed eight decision problems. Each subject was presented with 8 scenarios, varying regarding the award (50,000 or 250,000 NIS), the probability of getting the award (90% or 65%), and the CF rate (20% or 55%). These three factors were manipulated orthogonally within-subject. In addition, two different presentation orders of the eight problems, as well as two orders of the CF and FF options, were counterbalanced across subjects. All cases involved physical injury caused during a medical treatment in a hospital (“damage to the left hand” in the 50,000 NIS scenarios and “severe damage to the right hand” in the 250,000 NIS ones). In all scenarios, the attorney was expected to work 50 hours on the case. Subjects were asked to decide which fee arrangement, CF or FF, they would prefer as a plaintiff. The complete list of cases, with the numerical details for each one of them, is presented in Table 4.
Table 4
Cases employed in Experiment 2

<table>
<thead>
<tr>
<th>case</th>
<th>Award</th>
<th>Prob.</th>
<th>%CF</th>
<th>EV</th>
<th>ECF</th>
<th>FF</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
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<td>20</td>
<td>32,500</td>
<td>6,500</td>
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</tr>
<tr>
<td>2</td>
<td>50,000</td>
<td>.65</td>
<td>55</td>
<td>32,500</td>
<td>17,875</td>
<td>7,150</td>
</tr>
<tr>
<td>3</td>
<td>50,000</td>
<td>.90</td>
<td>20</td>
<td>45,000</td>
<td>9,000</td>
<td>3,600</td>
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<td>55</td>
<td>162,500</td>
<td>89,375</td>
<td>35,750</td>
</tr>
<tr>
<td>7</td>
<td>250,000</td>
<td>.90</td>
<td>20</td>
<td>225,000</td>
<td>45,000</td>
<td>18,000</td>
</tr>
<tr>
<td>8</td>
<td>250,000</td>
<td>.90</td>
<td>55</td>
<td>225,000</td>
<td>123,750</td>
<td>49,500</td>
</tr>
</tbody>
</table>

Results. Table 5 presents the percent in which participants preferred CF over FF in each case. A repeated measure ANOVA predicting choice in each of the eight cases from claim value, probability of success and lawyer’s share, yielded a significant effect for probability of success as well as a significant effect for the claim value. The effect of the lawyer’s share did not approach a significant level (p=.3), and neither did any of the interactions. Overall, respondents preferred CF in 4.49 out of 8 cases. Thus, in 58% of the choices (excluding avoidance) respondents preferred the CF option over FF even when expected CF was 2.5 times higher than FF.

Table 5
Percent of CF choices, out of all non-avoidance choices, N=43

<table>
<thead>
<tr>
<th>Claim Sum</th>
<th>50,000</th>
<th>250,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Probability of Success</td>
<td>65%</td>
<td>90%</td>
</tr>
<tr>
<td>CF = 20%</td>
<td>64.3</td>
<td>23.8</td>
</tr>
<tr>
<td>CF = 55%</td>
<td>68.3</td>
<td>34.1</td>
</tr>
</tbody>
</table>

4. Experiment 3: Neutralizing Incentives

The purpose of the third experiment was to examine the client’s preference for CF over FF when the client’s payment is decoupled from the lawyer’s fee arrangement. In these questionnaires the clients chose among the same two options for their agreement with a firm.

64 F(1,42)=42.743, p<.001 and F(1,42)=17.99, p<.001, respectively.
65 In each cell, no more than 3 respondents chose the avoidance option.
but the firm hired a lawyer to handle the case either on a CF basis or on a FF basis, irrespective of how the client paid. Thus, preference for CF or FF agreement with the firm could not be motivated by the client’s consideration of the lawyer’s incentive.

Participants. 44 students (23 men and 21 women) participated in the study in exchange for 5 NIS. Their ages ranged from 20 to 41, with a mean of 24.

Experimental Design. The same set of cases was used as in Experiment 2. However, the legal fees were paid to a firm handling such cases. The firm hired a lawyer to work on the case, and the lawyer was paid either a fixed fee or a contingent fee. Thus, a typical question read as follows:

Imagine that your left hand was harmed during a medical treatment in a hospital and you are considering claiming damages from the hospital. The estimation is that, if the court will find the hospital liable, you will get 50,000 NIS in damages, that the chances of success are 65%, and that the lawyer who’ll handle the case will have to spend about 50 working hours.

You may choose one of the following three options:

A. Ask a firm that handles such claims to hire a lawyer who will handle the damages claim for 20% of the sum received following his handling of the case (if the damages are obtained, you will pay the firm 10,000 NIS, and if no damages are obtained, you will pay the firm nothing). Assume that the firm is bearing all the costs involved in handling the case and that the firm is paying the lawyer some fixed sum for his work, irrespective of the outcomes of his work.

B. Ask a firm that handles such claims to hire a lawyer who will handle the damages, and pay it a fixed sum of 2,600 NIS (that you will pay the firm even if you will get no damages). Assume that the firm is bearing all the costs involved in handling the case and that the firm is paying the lawyer some fixed sum for his work, irrespective of the outcomes of his work.

C. Avoid handling the matter.

What option would you prefer? (Circle the appropriate answer) A   B   C

The method of lawyer’s remuneration by the firm was varied between subjects. Thus, in half of the questionnaires, instead of the words “… the firm is paying the lawyer some fixed
sum for his work, irrespective of the outcomes of his work” (in both options A and B), the phrase was: “… the firm is paying the lawyer a certain percent of the sum obtained following his work.” As in Experiment 2, the other three factors of interest, namely the claim sum, the probability of success and the CF, were manipulated orthogonally within-subject. In addition, two orders of the CF and FF options were counterbalanced across subjects. As in the previous experiment, all cases involved physical injury. The responder was asked to play the plaintiff’s role and decide which fee arrangement he or she prefers. The complete list of cases including the CF and FF values was identical to the one presented in Table 4.

Results. Across all cases, CF was preferred 50% of the time. Although preference for CF seems somewhat higher when the lawyer was paid contingent on the outcome than when the lawyer’s pay was not contingent (55% v. 46%) this difference does not reach a significant level.\(^66\) A comparison between the preference for CF in the present experiment—in which the lawyer’s incentives were normatively irrelevant—and the preference for CF in Experiment 2—where incentivizing the lawyer could have played a role in the subject’s choices—does not yield a significant difference between the two.\(^67\)

Table 6 presents the percent of choices in which participants preferred CF over FF, for each condition and for each case. We again used a repeated measure ANOVA of the choice in each of the eight cases by claim value, probability of success and lawyer’s share. The analysis essentially replicated the results of Experiment 2, showing a significant effect of the probability of success and of the claim value,\(^68\) but no significant effect of the CF percent (p=.2) and no significant interactions.

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\(^{66}\) t(42)=1.209, p=.23.

\(^{67}\) Even if one separately compares the results of each of the two conditions of Experiment 3 with the results of Experiment 2, the effect is not statistically significant. When comparing the condition in which the lawyer’s fee is contingent with the results of Experiment 2, there is clearly no significant difference (F(1,104)=.459, p=.5). When comparing the condition in which the lawyer is paid a fixed fee to the results of Experiment 2, the difference is closer to reach statistical significance, but is still not significant (F(1,104)=3.227, p=.075).

\(^{68}\) F(1,36)=49.98, p<.001 and F(1,36)=15.162, p<.001, respectively.
D. ANALYSIS AND NORMATIVE IMPLICATIONS

The above results shed light on several major issues in the theoretical and policy debates concerning CF. Specifically, we shall argue that these results –

- establish that prospect theory provides a convincing explanation for plaintiffs’ preference for CF;
- indicate that while incentivizing the lawyer is an important factor in choosing between different fee arrangements, it is not the only, and probably not even the primary, factor. Loss aversion, as predicted by prospect theory, is plausibly more important;
- seem to refute the claim that CF rates are excessive primarily due to asymmetric information. Information problems probably do not loom large on the plaintiffs’ preference for CF, and thus imposing disclosure duties is unlikely to have a very significant effect on the market.

**Loss Aversion v. Risk Aversion.** In Experiment 1, where the ratio between FF and ECF, calculated by multiplying the CF rate by the probability of recovery and by the sum of recovery) was approximately 1:3.3, 43% of the subjects nevertheless preferred CF. In Experiment 2, where the ratio between the FF and the expected CF was 1:2.5, 58% of the subjects preferred CF. One may thus conjecture that the mean indifference point between CF and FF (the ratio in which half of the plaintiffs would opt for CF), for a broad range of claims,

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In each cell, no more than 2 respondents chose the avoidance option.

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Table 6
Percent of CF choices, out of all non-avoidance choices, N=44

<table>
<thead>
<tr>
<th>Claim Sum</th>
<th>50,000</th>
<th>250,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Probability of success</td>
<td>65%</td>
<td>90%</td>
</tr>
<tr>
<td>Lawyer is paid on a CF basis</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CF = 20%</td>
<td>68.4 21.1</td>
<td>94.7 21.1</td>
</tr>
<tr>
<td>CF = 55%</td>
<td>76.5 26.3</td>
<td>88.9 50.0</td>
</tr>
<tr>
<td>Lawyer is paid on a FF basis</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CF=20%</td>
<td>47.8 20.0</td>
<td>79.2 28.0</td>
</tr>
<tr>
<td>CF=55%</td>
<td>52.2 25.5</td>
<td>70.8 45.8</td>
</tr>
</tbody>
</table>
is somewhere in between the two ratios used in the two experiments.\textsuperscript{70} In Experiment 5, described in Section IV.B below, where the ratio between FF and expected CF was 1:2, 57% of the subjects making the choice as plaintiffs preferred CF. A plausible explanation for the fact that in Experiment 5, where the FF:ECF ratio was 1:2, almost the same percentage of subjects opted for CF as in Experiment 2 (where the ratio was 1:2.5), is that the mean probability of success in Experiment 5 (90%) was higher than the mean probability of success in Experiment 2 (77.5\%). As the results of Experiment 2 indeed point out, the attractiveness of CF decreases as the probability of success increases.

The above results provide important clues to understanding plaintiffs’ behavior in the market for legal services. First, the results reinforce the descriptive, explanatory force of the prospect theory compared to expected utility theory. The fact that in our experiments, most subjects preferred CF over FF even when the ECF were 2 or 2.5 times higher than FF, and that 43% of the subjects opted for CF even when ECF was around 3.3 times higher than FF, seems implausible under conventional rational choice theory, yet is perfectly compatible with prospect theory. As explained earlier, a unique feature of the choice between CF and FF is that it resembles a choice between a pure positive gamble and a mixed gamble.\textsuperscript{71} Our findings of strong preference for CF even when the ECF is much larger than the FF, thus extend Payne and his colleagues’ findings of preference for pure gain gambles over mixed ones when the two are equal with respect to expected value.\textsuperscript{72}

The above results are compatible with prospect theory and incompatible with the standard notion of risk aversion in two additional important respects. First, according to the standard economic notion of risk aversion, people who are more affluent are expected to be less risk averse with regard to any given financial risk. If this were true, we should have expected a significant difference between the choices made by students and those made by practicing tort lawyers, who can safely be assumed to be much richer on average. Experiment 1 shows that

\textsuperscript{70} In another experiment, subjects were provided with a table of six different sums of FF, ranging from one quarter to one half of the ECF (FF being 25\%, 30\% ... or 50\% of ECF), and for each FF they were asked to choose between FF and CF. Out of the 35 subjects who seemed to have understood the questions, 13 invariably opted for CF, thus indicating that they prefer CF even when the expected CF is more than four times higher than FF. 8 subjects invariably opted for FF, thus indicating that they prefer FF even if the expected CF is less than twice higher than FF. For the remaining 14 subjects, the average indifference point, across choices, was a ratio of 38\% between the FF and the expected CF, which is a ratio of 1:2.6.

\textsuperscript{71} A similar observation was made by Rachlinski regarding the effect of different fee arrangements on the framing of decisions whether to accept a settlement offer. Rachlinski, supra note 8, at 129 n.64.

\textsuperscript{72} See Payne et al., supra note 43 and accompanying text. We also conducted a series of experiments in which subjects were asked to choose between pure positive and mixed gambles straightforwardly presented as gambles, rather than as choices pertaining to legal services. The results of these experiments are even more dramatic than those described in the present Article. See Ilana Ritov & Eyal Zamir, Pure Gambles, Mixed Gambles, and Attorneys’ Contingent Fees (unpublished manuscript).
lawyers’ preferences are almost identical to those of students and university applicants. Second, according to the standard notion of risk aversion, subjects’ choices should have depended on the magnitude of the sum involved. For any given probability of risk, the larger the sum involved the more people are presumed to be risk averse. In fact, the preference for CF was manifest even when the sums were very small. For example, in case 1 of Experiment 1, 50% of the lawyers in the personal injury scenario and 37% of the lawyers in the property damage scenario preferred CF over FF, despite the fact that the expected CF was 3.25 times higher than FF, and the fixed fee was only 600 NIS (approximately $150)! This extreme loss aversion is perfectly compatible with prospect theory but can hardly be explained by rational choice theory, at least under standard assumptions concerning the shape of people’s utility curve.  

Our results nicely coincide with the empirical findings reported by Herbert Kritzer: “Interestingly, most of the lawyers who told me that they had recommended to a client that a matter be handled on an hourly basis found that clients almost always opted for the contingency fee when advised of even the slightest possibility of a downside risk.”

Our analysis assumes that plaintiffs frame the choice between CF and FF as a choice between a pure positive and a mixed gamble. Arguably, a plaintiff who suffered injury or loss may view her pre-injury/loss position as the pertinent reference point, and thus view even positive recovery as a loss, as long as the recovery is smaller than her losses. There are, however, good reasons to believe that this is not the case. As further elaborated in Section IV.C below, the lapse of time between the injury or loss and the time in which a plaintiff faces the choice of fee arrangement is likely to make her view her current, post-injury/loss position as the status quo. Also, when the injury suffered is at least partially non-monetary, the claimed damages may put her in a better monetary position even compared to her pre-injury position.

Of course, market prices depend not only on the demand for a certain good or service, but also on the supply side. In a perfectly competitive market one would expect prices to drop to the level of minimal or no profit to suppliers. The fact that CF rates result in high effective hourly rates cannot, therefore, be explained solely by focusing on the demand side. This leads

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74 Kritzer, Wages of Risk, supra note 2, at 305-06.
75 For further details, see infra notes 163-168 and accompanying text.
us to examine two other explanations offered in the literature for the fact that CF arrangements are prevalent and CF rates are high.

**Loss Aversion v. Efficient Incentives.** Numerous studies of different fee arrangements have analyzed the incentives they create for the lawyer, especially given that most clients lack effective means of monitoring the lawyer’s performance. The incentive effect is considered not only a key factor in choosing among different fee arrangements, but also a central explanation for why CF rates are set above the competitive zero-profit rate. A low CF rate may decrease the attorney’s incentive to invest time and skill in the case, thus decreasing—rather than increasing—the plaintiff’s expected net recovery (the award minus the lawyer’s fee).

Can the incentive effects of CF arrangements explain the choices made by the participants in our experiments?

In all three experiments, the chances of getting the award were presented in the opening paragraph of each question, thus implying that the prospects of obtaining the award were independent of the choice of fee arrangement presented later on in the question. However, this formulation did not entirely rule out the possibility that at least some respondents assumed, consciously or unconsciously, that CF is preferable because it would increase the chances of getting the award or the magnitude of recovery.

To neutralize the possible incentive effects of different fee arrangements, Experiment 3 clearly and explicitly decoupled the fee arrangement made between the plaintiff and the firm from the fee arrangement made between the firm and the lawyer who actually handles the case. While this decoupling somewhat decreased the preference for CF, from 58% in Experiment 2, to 50% in Experiment 3, this decrease was not significant. Even if the decrease were significant, this difference would have only meant that incentives do play some role in the choice between different fee arrangements—an observation that is obviously true. The striking result is that even when incentives were neutralized, 50% of the respondents opted for CF when the fee they were expected to pay (ECF) was 2.5 times higher than the FF. This result is in tension with the assumption implicit in the economic analyses, namely that incentives are (and should be) the primary concern of the parties in shaping the fee arrangement.

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76 See supra notes 23-28 and accompanying text.
It may be contended that even in Experiment 3, the incentive effects of the CF were not absolutely neutralized. Some subjects might have surmised that even if the lawyer is paid a fixed fee, paying the firm on a CF basis would induce it to use other means, such as monitoring the lawyer more closely, to increase the probability of winning the case. At the same time, a firm that is paid on a FF basis may hire less experienced lawyers or pay CF rates that are too low to create sufficient incentives for success. While it is impossible to rule out such conjectures altogether, given the design of the experiment, we believe that its results do cast serious doubt on the centrality of incentives in the present context. It is difficult to quantify the relative importance of incentives and of loss aversion in people’s choice of CF and in setting the CF rate. Inasmuch as they accurately reflect people’s behavior in the real world, our experiments demonstrate that loss aversion is certainly a major factor, probably the primary one.

Asymmetric Information? A competing explanation for the prevalence of CF and its high rates has been that the market for legal services is not competitive due to clients’ acute information problems as to the expected reward, the risk involved in the suit, the quality of legal services provided, the time required to handle the claim, and so forth. While our findings do not refute this claim, they diminish its significance for two cumulative reasons. First, in all of our experiments, subjects were provided with clear information concerning the reward they might expect and the probability of success. In Experiment 3 (as well as in some of the experiments described below), subjects were also provided with information about the time required to handle the case. In fact, since the participants faced a choice between CF and FF, and not between CF and an hourly rate, information about the amount of work necessary to handle the case was irrelevant. Similarly, since in our experiments there was no indication that the choice between the different options would affect the quality of legal services, this information was not relevant either (or so one can reasonably assume). Thus, while it is true that clients often lack relevant information, our experiments indicate that the availability of all relevant information is unlikely to have a major effect on their preferences. A majority of

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78 See supra note 22 and accompanying text.*
respondents preferred CF over FF even when the data presented to them indicated that ECF was 2 or 2.5 times higher than FF.

Even more importantly, Experiment 1 established that the preferences of experienced tort lawyers who regularly charge their clients on a CF basis—and who are therefore very knowledgeable about the advantages and disadvantages of CF arrangements—are almost identical to those of lay persons. It is therefore quite clear that lack of information does not play a significant role in plaintiffs’ choices of fee arrangements.⁷⁹

This is not to say that plaintiffs are sufficiently informed when they hire a lawyer on a contingent (or any other) fee basis or that additional information would not be of use to them. For example, our results support the intuition that lawyers have an incentive to portray the prospects of success in any case brought to them as lower than what they truly estimate them to be, to strengthen the client’s tendency to opt for CF. As Table 5 shows, for any claimed sum and for any CF rate, respondents’ preference for CF over FF rose dramatically when the probability of success dropped from 90% to 65%.

Furthermore, the percentage of respondents who opted for CF in our experiments is appreciably lower than the percentage of plaintiffs, in both Israel and the United States, who resort to CF arrangements in such spheres as personal injury. The fact that in such cases almost all lawyers charge their clients on a CF basis must therefore reflect additional factors, including the latter’s information problem and financial constraints. Obviously, one party’s preferences are not the only factor determining the terms of a bilateral transaction. Lawyers’ unwillingness to offer alternative payment arrangements surely plays a significant role as well. An additional factor that may play a role is people’s documented excessive discount rate: people tend to underestimate future costs and benefits compared to present ones.⁸⁰ Since under CF arrangements payment is ordinarily deferred to the time of recovery, clients may fail to appreciate its true magnitude. Also, whereas in our experiments, to avoid excessive complexity, subjects were offered a choice between CF and FF, in the actual market for legal

⁷⁹ Our findings regarding the preferences of experienced tort lawyers may—or may not—bear on the question whether sophisticated, repeat players overcome the “biases” predicted by prospect theory (see supra notes 40-41 and accompanying text). To begin with, this controversy is largely irrelevant in the present context, as most of the plaintiffs in the areas where CF arrangements are used are in fact unsophisticated, one shot players. As for the choices made by the tort lawyers, while it may be argued that they contradict the contention that experienced professionals act in accordance with the predictions of rational choice theory; it may also be argued that these people are experts in representing plaintiffs, not in being ones.

⁸⁰ On people’s tendency to attribute too little weight to future benefits and costs, as compared to present ones, see, e.g., Dilip Soman, The Illusion of Delayed Incentives: Evaluating Future Effort-Money Transaction, 35 J. MARKETING RES. 427 (1998) (finding that consumers tend to underestimate future effort required of them to gain some future benefit); Marjorie K. Shelley, Gain/Loss Asymmetry in Risky Intertemporal Choice, 59 ORGANIZATIONAL BEHAV. & HUM. DECISION PROC. 124 (1994) (finding that the discount rate for future losses is larger than for future gains).
services the major alternative to CF is hourly fee. Hourly fees are considerably less attractive than fixed fees because of the uncertainty concerning the scope of work the case will require. Finally, the gap between ECF and other fee arrangements may in reality be smaller than in our experiments.\textsuperscript{81}

In any case, on the basis of our findings, and especially considering the similarity between lay persons’ and professionals’ preferences, we doubt that imposing disclosure duties on lawyers would make a substantial difference in market behavior. The same holds true for requiring lawyers to offer their prospective clients a choice between different fee arrangements. Despite the explicit, and even highlighted, availability of such alternatives in our experiments, respondents manifested a strong preference for CF arrangements. Arguably, people have a right to obtain all relevant information and to choose among different options before making a contract, even if this information and these options are unlikely to affect their decisions.\textsuperscript{82} We have no quarrel with this view, but one must remember that the imposition of such duties increases the transaction costs, that are then divided between the parties.

Another argument might be that, if additional information and more options are unlikely to affect plaintiffs’ behavior, then the deviation of plaintiffs’ preferences from the predictions of standard rational choice theory may justify a paternalistic regulation, e.g., by capping CF rates. While we accept that legal paternalism is sometimes desirable and even efficient,\textsuperscript{83} we doubt that there is enough reliable information regarding the CF market to warrant such regulation on paternalistic grounds. Even if people may gain more by displaying less loss aversion, the complexity of factors affecting the choice of fee arrangement (including clients’ financial situation, their loss aversion and the incentive effects of different arrangements), as well as the incompleteness of the empirical data, militate against paternalistic regulation in this sphere. Also, from a deontological perspective, limiting people’s freedom for their own sake seems much more justifiable when done to prevent loss and suffering than when it is done to ensure greater monetary gain.\textsuperscript{84}

\textsuperscript{81} On the factual debate, see supra Section I.A. See also infra note 166.
\textsuperscript{82} See, e.g., Gwen Bymers, Seller-Buyer Communication: Point of View of a Family Economist, 64 J. HOME ECON. 59, 59 (1972) (“The use the consumer makes of information is peripheral to the main issue of right to know”); William C. Whitford, The Functions of Disclosure Regulation in Consumer Transactions, 1973 WIS. L. REV. 400, 404 (arguing that “disclosure regulation might be justified even if it were primarily intended to induce sellers to actually disclose the required information,” thus making the relations between the parties “more honest, even if there is no change in consumer behavior or the content of transactions”).
\textsuperscript{83} See, e.g., Eyal Zamir, The Efficiency of Paternalism, 84 VA. L. REV. 229 (1998) (arguing that paternalism is compatible with economic efficiency).
II. WHAT DETERMINES THE FAIRNESS OF A CONTINGENT FEE?

A. NOTIONS OF FAIRNESS AND THEIR RELEVANCE TO CONTINGENT FEES

People’s perceptions of the fairness of CF are important for two reasons. First, it stands to reason that profit seeking firms (including attorneys) take judgments of fairness into account when setting their prices. Various studies have indicated that people do not view agreed upon prices, or prices determined by the supply and demand in a certain market at a given point in time, as ipso facto fair. Firms that wish to enhance their reputation (and decision makers in the firm who prefer to act “fairly”) may thus be expected to take the prevailing notions of fairness into account. Assume, for instance, that due to small expected recovery or slim chances of success, representing a plaintiff on a CF basis in a certain case is deemed profitable only if the CF would be 70% of the recovery. If the attorney knows that such a CF would be considered unfair by most people and hence adversely affect her reputation once made public, she would probably refuse to take the case on a CF basis. Even if the client is perfectly willing to hire her on this basis, the attorney will either refuse to take the case or accept it on an hourly fee basis (explaining to the client, so one should hope, the expected costs and benefits of pursuing the case).

The second reason why prevailing judgments of fairness are relevant to the CF debate is that they are likely to affect the regulation of CF, both ex ante, when legislators and other policy makers consider whether and how to regulate CF, and ex post, when judges are called upon to supervise such arrangements. Judges and legislators often lack the macro-economic data and expertise necessary to evaluate the competitiveness of a market or the efficiency of a regulatory measure. In fact, even experts often disagree about these issues (as the CF debate

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86 Kahneman, Knetsch & Thaler, supra note 85, at 736-37 (providing evidence that the following considerations may lead firms to respect community standards of fairness: 1. Unfair behavior may induce customers to take their business elsewhere when relations rest on trust; 2. Customers may avoid contracting with unfair firms at some cost to themselves even when trust is not an issue; 3. Firms’ officials may have preference for acting fairly). Cf. George A. Akerlof, The Case against Conservative Macroeconomics: An Inaugural Lecture, 46 ECONOMICA 219, 230-33 (1979) (arguing that it is rational for profit maximizing firms to follow standard business practices which disallow the payment of market-clearing wage under some circumstances).

87 An indirect support for this conjecture may be found in the answers lawyers gave Herbert Kritzer when asked to explain why they sometimes collect fees that are less than what the retainer agreement entitles them to: “some lawyers expressed the view that the lawyer should not walk away with more than the client; in cases in which substantial payments had to be made to subrogated parties, lawyers often reduced their fee to a level that they split with the client what was left after paying the subrogated claims.” KRITZER, Risks, supra note 2, at 41.
demonstrates). Judges and regulators may thus base their decisions on notions of fairness. Furthermore, even if uncontested economic data is available, policy makers may view fairness as a more appropriate criterion for regulation, or unconsciously base their decisions on notions of fairness. To the extent that policy makers are affected by public opinion, and public opinion reflects prevailing standards of fairness, policy makers will be affected by such standards.  

Existing studies of fairness judgments only partially contribute to the understanding of such judgments concerning CF rates. One body of literature focuses on the fairness of prices, including wages and rents (“pricing fairness”). These studies have forcefully established the importance of reference points in making such judgments. The reference point may be the prices paid by other customers or the wages paid to other people in the industry. It may also be the prices a firm ordinarily charges for a certain good or the wages it ordinarily pays. This would be the pertinent reference point when a firm considers raising prices or cutting salaries in response to sudden changes in the demand for its products or unemployment rates at a certain locality. There is no reason to assume that legal fees are in any way different from other prices in this respect. In fact, the manifest standardization and stability of CF rates are plausibly reinforced by the prevailing perception of these rates as fair.

This body of literature, however, takes existing rates as a reference point; it does not answer the question why certain rates have come to dominate the market. This latter question is, however, crucial for both the positive and normative inquiry. Positively, are current rates the happy result of a functioning competitive market, or the unfortunate outcome of a major market failure? Normatively, should CF rates be statutorily or judicially controlled?

Another body of literature on fairness judgments comes from experimental game theory (“division fairness”). Numerous studies of bargaining games, such as Ultimatum and Dictator,
have established that under most circumstances, people do not behave as rational maximizers of their own utility. Instead, they give considerable weight to notions of fairness.92 People are even willing to bear some costs to punish others for what they perceive as an unfair division of resources.93 There is an obvious similarity between these studies and CF in the sense that CF highlights the division of a pie, the expected recovery, between two people, the plaintiff and her attorney.

There are, however, important differences between CF and such bargaining games. CF is not only, or even primarily, a way to divide a certain pie; it is chiefly a way to remunerate the attorney for her time and skill and to provide her with an incentive to win the case. In that sense, the pertinent fairness judgment refers to the equivalence between the attorney’s work and her remuneration (“fairness of exchange”). Put differently, while pricing fairness would compare a particular CF rate with the prevailing rates in the market, and division fairness would compare the attorney’s share of the recovery to the client’s share, fairness of exchange compares the attorney’s fee to the value of her work. To circumvent the difficulty of making such a comparison in the abstract, one may compare the effective hourly fee resulting from CF with the hourly fee the attorney would have charged for similar services.94 Alternatively, the expected CF may be compared to a fixed, global fee that the attorney would have charged for handling the same case. Note that while all three notions of fairness involve comparisons, only pricing fairness and fairness of exchange necessarily involve a comparison to external reference points (such as the CF ordinarily charged and the hourly fee that would have been charged for the same service, respectively). Division fairness may be assessed by comparing the shares each person gets of the entire pie, without resorting to any external reference. Clearly, the fairness of a certain CF rate may in any particular case be deemed fair according to one conception of fairness and unfair according to another.

92 In game theory, Ultimatum is a game in which one person (the proposer) is asked to divide a sum of money between herself and another person, and the other person (the responder) may either accept the proposed division, in which case the division is implemented, or reject it, in which case both players receive nothing. In a Dictator game, one party unilaterally decides how to divide a sum of money between herself and another person. Rational choice theory predicts that in an Ultimatum game the proposer will offer the responder the smallest unit of money used in the game and the responder will accept this offer; and that in a Dictator game the dictator will appropriate the entire sum. Numerous experiments, however, have established that in Ultimatum games most proposers offer responders a generous share of the pie (40% on average), and that even in Dictator games, though the offers were much lower, in most cases they were still positive. For a general survey and analysis of the experimental data, see COLIN F. CAMERER, BEHAVIORAL GAME THEORY – EXPERIMENTS IN STRATEGIC INTERACTION 43-117 (2003).

93 In Ultimatum games, responders typically reject offers of 20% or so half the time. See CAMERER, id., at 43.

94 One has to make adjustments for the fact that usually CF compensates the attorney not only for the working hours she spends on the case, but also for additional expenses and costs, whereas in other fee arrangements these additional costs are ordinarily billed separately. In our experiments this difference between CF and other fee arrangements was neutralized by informing the participants that under both the CF and FF options the lawyer will bear all costs involved in handling the case.
As indicated above, *pricing fairness* is unhelpful when assessing the fairness of the standard CF rate (unlike deviations from it). Of the two remaining measures, *fairness of exchange* and *division fairness*, only the first should presumably be considered relevant in the context of CF. Compare, for instance, a case in which the expected recovery is $50,000 and the prospect of recovery is 75%, with a case in which the expected recovery is $500,000 and the prospect of recovery is 90%. Let us further assume that the ordinary hourly fee for legal services in the relevant locality is $250, that handling each of the cases is expected to require 125 hours, and that the standard CF is 1/3 of the recovery. If both cases are taken on the basis of a CF of 33%, the attorney is expected to get an effective hourly fee of $100 in case A, and $1,200 in case B.\(^5\) Put differently, for the same amount of work, the lawyer is expected to earn $12,500 in case A, and $150,000 in case B (compared to $31,250 had she charged a FF based on the normal hourly fee multiplied by the amount of expected hours). Presumably, then, in case A, a CF rate of 80%, resulting in expected fee of $30,000 and effective hourly fee of $240, should be deemed perfectly fair and possibly even too low (given the insurance and credit elements embodied in CF). At the same time, in case B, a CF rate of 20% (resulting in expected CF of $90,000 and effective hourly fee of $720), should be considered unreasonably high.

What factors actually determine the perceived fairness of CF rates? How do people react when the plaintiff gets a smaller share than the attorney? Assuming that judgments of fairness can directly (through the market) and indirectly (through the interplay between market actors and regulators) affect CF rates, we set out to identify what factors bear on these judgments. Since the structure of the CF arrangement brings to mind notions of division fairness, we hypothesized that the CF rate would have greater effect on people’s perceptions of fairness than the sum of the claim, the probability of success and the effective hourly rate.

**B. EXPERIMENT 4: JUDGMENTS OF FAIRNESS**

This experiment explored how the perceived fairness of CF arrangements is affected by the magnitude of the sum claimed, the probability of success and the CF rate. In a previous experiment we found no significant correlation between the perceived fairness of CF arrangements and any of the following variables: 1. the timing of evaluation (prior to contracting with the lawyer v. following the successful handling of the case but before paying the fee); 2. the type of harm (personal injury v. property damage); and 3. the evaluator’s

\(^5\) $50,000 \times .75 \times .33 \div 125 = $100; \quad $500,000 \times .90 \times .33 \div 125 = $1,200.$
position (the client v. a disinterested third person). This lack of correlations may either accurately reflect people’s judgments of fairness in the real world, or stem from the abstract nature of the laboratory experiment. At any rate, in light of the results of that experiment, in the present experiment all questions referred to personal injuries and all subjects were asked to make their judgments from the perspective of a third person, prior to contracting.

Participants. 113 students and university applicants (46 men, 67 women) participated in the study in exchange for 5 NIS. Their ages ranged from 19 to 67, with a mean of 26.

Experimental Design. We employed eight cases. Each one included details of the claim and the CF arrangement. All cases involved personal injury, and were evaluated ex ante, from the perspective of an uninvolved observer. In all cases the lawyer was expected to spend 100 working hours on the case. Three factors were varied orthogonally within subject: the amount claimed (100,000 v. 500,000 NIS), the probability of success (65% v. 90%) and the proportion of CF (20% v. 55%). The complete list of cases, with the numerical details for each, is presented in Table 7. In addition, the order of the problems was counterbalanced between subjects, using four different presentation orders. For each problem participants were asked to indicate their evaluation of the fairness of the agreement on a scale ranging from 1 (“definitely fair”) to 9 (“unfair and excessive”).

Table 7
Cases employed in experiment 4

<table>
<thead>
<tr>
<th>Case</th>
<th>Award</th>
<th>Prob.</th>
<th>EV</th>
<th>%CF</th>
<th>ENV</th>
<th>ECF</th>
<th>Hours</th>
<th>EEHR</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>100,000</td>
<td>.65</td>
<td>65,000</td>
<td>20</td>
<td>52,000</td>
<td>13,000</td>
<td>100</td>
<td>130</td>
</tr>
<tr>
<td>2</td>
<td>100,000</td>
<td>.65</td>
<td>65,000</td>
<td>55</td>
<td>29,250</td>
<td>35,750</td>
<td>100</td>
<td>357.5</td>
</tr>
<tr>
<td>3</td>
<td>100,000</td>
<td>.90</td>
<td>90,000</td>
<td>20</td>
<td>72,000</td>
<td>18,000</td>
<td>100</td>
<td>180</td>
</tr>
<tr>
<td>4</td>
<td>100,000</td>
<td>.90</td>
<td>90,000</td>
<td>55</td>
<td>40,500</td>
<td>49,500</td>
<td>100</td>
<td>495</td>
</tr>
<tr>
<td>5</td>
<td>500,000</td>
<td>.65</td>
<td>325,000</td>
<td>20</td>
<td>260,000</td>
<td>65,000</td>
<td>100</td>
<td>650</td>
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<tr>
<td>6</td>
<td>500,000</td>
<td>.65</td>
<td>325,000</td>
<td>55</td>
<td>146,250</td>
<td>178,750</td>
<td>100</td>
<td>1,787.5</td>
</tr>
<tr>
<td>7</td>
<td>500,000</td>
<td>.90</td>
<td>450,000</td>
<td>20</td>
<td>360,000</td>
<td>90,000</td>
<td>100</td>
<td>900</td>
</tr>
<tr>
<td>8</td>
<td>500,000</td>
<td>.90</td>
<td>450,000</td>
<td>55</td>
<td>202,500</td>
<td>247,500</td>
<td>100</td>
<td>2,475</td>
</tr>
</tbody>
</table>

96 In this Table, EV denotes the Expected Value of the claim (the sum claimed multiplied by the probability of getting it); ENV is the Expected Net Value of the claim (EV minus ECF, the Expected Contingent Fee); and EEHR is the Expected Effective Hourly Fee (ECF divided by the number of hours the attorney is expected to spend on the case).
A typical question read as follows:

Imagine that a person was harmed during medical treatment in a hospital, and he is considering suing the hospital for damages. The estimation is that if the court will find the hospital liable, that person will receive damages of 100,000 NIS, the claim’s chance of success is 65%, and the lawyer who will handle the case will have to spend 100 hours. The lawyer whom this person approached is willing to take the case for a fee of 20% of the awarded damages (that is, the lawyer will get 20,000 NIS if the suit will succeed and 0 if the suit will be dismissed).

How would you describe this fee along a scale of 1 to 9, where 1 indicates a definitely fair fee and 9 indicates an unfair and excessive fee (mark one number).

Definitely fair 1 2 3 4 5 6 7 8 9 Unfair and excessive

Results. Although order had a significant effect across problems, it did not significantly interact with any of the three factors. Our main concern is the effect of the three factors (claim sum, probability of success and CF rate). Hence for the following analyses we collapsed the data across orders. Table 8 presents the mean unfairness rating for all combinations of the three factors.

<table>
<thead>
<tr>
<th>Table 8</th>
<th>Mean unfairness ratings</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>100,000</td>
</tr>
<tr>
<td>Probability of Success</td>
<td>65%</td>
</tr>
<tr>
<td>CF = 20%</td>
<td>3.36</td>
</tr>
<tr>
<td>CF = 55%</td>
<td>6.14</td>
</tr>
<tr>
<td>Overall</td>
<td>4.75</td>
</tr>
</tbody>
</table>

Each of the three factors contributed significantly to the perceived unfairness of the lawyer’s fee. Specifically, the lawyer’s fee is perceived as more unfair the higher the total

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97 F(3,106)=6.173, p=.001, in a repeated measure ANOVA of fairness ratings by factors and order. The mean fairness rating across problems was higher in the two questionnaires that began with cases that were considered less unfair than in the two questionnaires that began with cases that were considered more unfair. Thus, the case encountered first seems to affect subsequent judgments perhaps due to a contrast effect.
claim, the higher the probability of success, and the higher the CF rate.\textsuperscript{98} These factors seem to have an additive effect on the evaluation, as none of the interactions reached a significant level. Although all three factors affect unfairness judgments (as each one of them affects the lawyer’s expected fee), the impact of the CF rate clearly overshadows the other two factors. We computed for each subject the difference in mean judgment between cases with high value and cases with low value for each of the factors. A repeated ANOVA of the three resulting differences showed a significant difference between the two: Increasing the CF rate from 20\% to 55\% increased unfairness by 2.70 on average (on a scale of 1 to 9), whereas increasing the claim from 100,000 to 500,000 NIS increased average unfairness only by .38, and increasing the probability of success from 65\% to 90\% increased average unfairness by .44 only (on the same scale). Thus the impact of the CF rate is several times greater than the impact of the other two factors.\textsuperscript{99}

C. ANALYSIS AND POLICY IMPLICATIONS

The finding that all three factors—the sum claimed, the probability of success and the CF rate—affect the perceived fairness of a CF arrangement makes perfect sense. The larger each of these factors, the higher is the lawyer’s fee, and thus the more it is likely to be considered as “unfair and excessive.”\textsuperscript{100} However, the disproportionate weight of the CF rate indicates that the fairness of CF arrangements is primarily seen as raising an issue of division fairness rather than fairness of exchange. Viewed from the latter perspective—as we argued above that it should presumably be judged—the results of the experiment are counterintuitive and even strange. Compare, for example, case 2, involving a 100,000 NIS claim with a 65\% probability of success and a lawyer’s share of 55\%, to case 7, involving 500,000 NIS claim with a 90\% probability of success and a lawyer’s share of 20\%. Although in the latter case the lawyer takes a smaller risk and her expected effective hourly rate is more than 2.5 times greater than in the former (900 NIS compared to 357.5 NIS), the fee arrangement in the latter case is considered much fairer (4.25 compared to 6.14, on a scale of 1 to 9). Similarly, although the effective hourly rate in case 5 is considerably higher than the effective hourly rate in cases 2

\textsuperscript{98} F(1,109)=10.239, F(1,109)=42.768, and F(1,109)=192.425, for claim value, probability of success, and CF rate, respectively, in a repeated measure ANOVA of the eight unfairness ratings by the three independent factors. \textsuperscript{p<.01} in all cases.

\textsuperscript{99} This conclusion should, however, be taken with care, as the differences between the high and low values of each of the three factors (claim sum, success probability and CF rate) and the scales on which they are indicated are dissimilar, and do not easily lend themselves to direct comparison.

\textsuperscript{100} Since the participants in this experiment were laypersons, who are unlikely to know what the prevailing rates in the market for legal services in Israel are, it is improbable that their judgments were in any way affected by a comparison between the details provided in the questions and the prevailing rates.
and 4 (650 NIS compared to 357.5 and 495 NIS, respectively), the CF in case 5 is considered much fairer than the CF in cases 2 and 4 (3.82 compared to 6.14 and 6.56, respectively).

These findings cohere with the rulings of American courts who supervise CF arrangements. While courts take into account the circumstance of the particular case, “[j]udicial tolerance of fee percentages seems to end at 50 percent.” Thus, rather than trying to calculate the effective hourly rate of any CF arrangement based on the specific characteristics of the case—the sum claimed, the probability of success, the scope of the expected work and the time it will take to attain the award—the courts tend to set uniform caps on the percentage of CF. Statutory regulations of CF rates, inasmuch as they exist in the United States and elsewhere, ordinarily use the same method of regulation. Notions of fairness are not the only possible explanation for this prevailing policy; the considerable costs of a more precise regulation, tailored to fit the specific characteristics of every case, are certainly pertinent as well. We nevertheless believe that the prevailing notions of fairness play a central role in this regard.

Very high CF rates may be mutually beneficial, especially if the size of the claim and its probability of success are relatively small and the plaintiff has no other means to finance legal services. According to the available data, however, such rates are actually rare. Can the perceived unfairness of very high CF rates explain its rarity?

Schematically, perceptions of unfairness can affect market behavior through clients’ choices, lawyers’ choices or regulation. To test the first possibility, Experiment 2 examined plaintiffs’ choices between CF and FF arrangements in 8 scenarios corresponding to the scenarios described in Experiment 4. The details of the cases used in Experiment 2 (presented in Table 4 above), closely follow the details of the cases used in Experiment 4 (described in Table 7) except for two complementary modifications. In both experiments we used the same set of cases in terms of the probabilities of success and CF rates. However, in Experiment 2 (the choice experiment) we divided both the claimed sum and the expected number of

102 See, e.g., ARONSON, supra note 101, at 82-93 (surveying judicial, statutory (state and federal), and ethical rules limiting CF); Brickman, supra note 3, at 32 (stating that “contingency fees in excess of fifty percent are typically precluded by court rule, statute, or custom”); Dwyer, supra note 7, at 615-17 (surveying existing and proposed statutory limitations on CF, and stating that the most common type of legislation “places a maximum on the percentage of allowable attorneys’ fees based on a sliding scale that decreases the percentage as the award gets higher,” while some states have imposed a fixed maximum). See also supra note 47 (statutory caps in Israel).
103 Excluding such claims may be socially efficient if the costs they impose on the court system are larger than their benefits to the parties involved. However, this consideration is unlikely to affect the behavior of the plaintiff and her attorney.
104 See KRITZER, RISKS, supra note 2, at 37-43 (summarizing several sources of empirical data).
working hours by 2. For instance, while case 8 in Experiment 4 (fairness) referred to a claim of 500,000 NIS with a 90% probability of success, a CF rate of 55%, and 100 working hours, the corresponding case in Experiment 2 (choice) referred to a claim of 250,000 NIS with the same probability of success and CF rate, but only 50 working hours. Hence, the effective hourly rate in both experiments was identical, but the expected CF was half as large in the choice experiment. This modification enabled us to use correspondingly smaller sums of FF in the choice experiment (FF = ECF/2.5), ranging from 2,600 to 49,500 NIS, which we assumed would be closer to what a student respondent could reasonably afford.

As described in Subsection I.C.2 above, while the probability of success and the sum claimed yielded a significant effect on the preference for CF over FF in Experiment 2, the effect of the CF rate did not approach a significant level. This result may seem surprising given the great difference between CF rates of 20% and 55%, and the robust difference in the perceived fairness of the two rates as found in Experiment 4. This result is less surprising once one recalls that, to maintain a constant ratio of 1:2.5 between the FF and ECF, the FF in the cases of the 55% CF rate was quite high—possibly prohibitively high for some of the respondents in some of the cases (as fixed and hourly fees are in fact for some plaintiffs in the real world).

More generally (and possibly more surprisingly for those unfamiliar with the relevant cognitive psychology literature), our results comport with the results of previous studies that found that the perceived fairness of different alternatives does not necessarily affect the choice between them. For instance, in one experiment, Max Bazerman and his colleagues presented students with a scenario where co-owners of a parcel of land were about to sell the land to a third party, and the proceeds of the sale were to be divided between them in different ways. Two of the self/other allocations were 500/500 and 600/800. Some subjects were asked to rank these (and other) allocations separately in terms of how satisfied they would be with them or how acceptable they are. Other subjects were asked to choose between these two allocations. While a clear majority of the subjects ranked the 500/500 allocation as more satisfying and more acceptable than the 600/800 (self/other) allocation, only a minority of the subjects actually opted for the first allocation when faced with the choice between them.105 As

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in Experiment 4, the satisfaction/acceptability judgment in Bazerman’s experiment clearly rests on “division fairness.”

To the extent that the rarity of very high CF rates has to do with its perceived unfairness, it thus seems that the intermediate mechanism is not plaintiffs’ preferences. Faced with a choice between very high CF rates (in cases whose size, probability of success or both are small), a relatively high non-contingent fee, or avoiding any action, plaintiffs are likely to opt for the very high CF. The remaining ‘candidate’ mechanisms are the preferences of attorneys who care about their reputation and do not like to be viewed as charging excessively high fees, and the interplay between the bar and courts and legislators who regulate CF rates. We have not tried to test these plausible hypotheses experimentally. It should be pointed out, however, that none of the three possible explanations accounts for the characteristic uniformity of CF rates, as the prevailing rate of 33% can hardly be said to be significantly more or less unfair than 32% or 34%. Additional factors, then, must play a role in setting CF rates in the market for legal services, to which we turn now.

III. WHY ARE CONTINGENT FEE RATES UNIFORM?

A. THE UNIFORMITY OF CONTINGENT FEE RATES

In the numerical example used in Section II.A above, we compared a case in which the claimed sum is $50,000 and the probability of recovery is 75%, with a case in which the claimed sum is $500,000 and the probability is 90%. Assuming that handling both cases requires a similar amount of time, charging the same CF rate in both cases would yield a total fee (as well as an effective hourly fee) that is 12 times greater in the latter case than in the former. From a conventional economic perspective, this outcome is puzzling. In a competitive market, the CF in each particular case should presumably be a function of the

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106 In another experiment, conducted by Amos Tversky and Dale Griffin, students were presented with a scenario in which they will face two options following graduation: working in job A for a yearly salary of $35,000, where their peers earn $38,000, and working in job B for $33,000, where their peers earn $30,000. Half the subjects were asked which job they would choose, and the other half were asked at which job they would be happier. While 84% of the students in the choice frame chose the job with the higher absolute salary, 62% of the students in the judgment frame anticipated higher satisfaction in job B. Given the design of the experiment, it seems that the higher satisfaction in job B is attributable to its greater fairness (in this case, what we labeled “price fairness”). It may be argued, though, that the subjects’ greater expected happiness in job B is not due to its greater perceived fairness but to their higher comparative status in this job. See Amos Tversky & Dale Griffin, Endowment and Contrast in Judgments of Well-Being, in SUBJECTIVE WELL-BEING: AN INTERDISCIPLINARY PERSPECTIVE 101, 113-15 (Fritz Strack et al. eds., 1991). Given the design of the experiment, it seems that the higher satisfaction in job B is attributable to its greater fairness (in this case, what we labeled “price fairness”). It may be argued, though, that the subjects’ greater expected happiness in job B is not due to its greater perceived fairness but to their higher comparative status in this job. See generally Richard H. McAdams, Relative Preferences, 102 YALE L.J. 1 (1992).

107 For simplicity’s sake, it is assumed that no other costs are involved in handling the case. Adding such costs would not change the basic argument, as each of the two cases may involve larger or smaller additional costs.
amount of the expected recovery, the probability of recovery, and the time, efforts and skill
the attorney is expected to invest in the case. Additionally, economic analysis predicts
varying CF rates as the fee serves as a mechanism by which the client and the attorney, each
of whom posses private information bearing on the case, can reliably convey this information
to the other party: the client with regard to the quality of the case and the attorney regarding
the quality of her services.

No such variance exists in the market for legal services, however. According to Herbert
Kritzer’s survey, about two thirds of the cases (excluding those governed by special
regulation) involve a fixed percentage (‘flat fee’) and about one third involve a variable
percentage. In 88% of the flat fee cases, the CF is 33% of the recovery. The common pattern
in the cases employing a variable percentage is to charge 25% of the recovery if the case does
not go to trial or does not involve substantial trial preparations; 33% if the case goes beyond
this point, and 40% to 50% if the case results in an appeal. Other sources confirm this
description. While Kritzer describes the notion that CF rates are uniform and standard as “a
myth,” his findings largely corroborate this perception.

Lester Brickman and others argue that the uniformity of CF percentage across cases that
differ markedly in terms of their expected recovery, probability of recovery and expected
work, is a clear indication of a market failure. Such market failure arguably justifies
regulation to ensure that clients pay the fee that would have been charged in a competitive
market, taking into account the characteristics of the individual case. However, as indicated
above, to the extent that legislatures and courts regulate CF, they tend to follow the market
pattern; setting uniform caps for CF rates regardless of the characteristics of the particular
case. It is therefore concluded that the prevailing rates reflect the interplay between
attorneys and regulators, including courts, rather than market forces. Arguably, these

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108 Brickman, supra note 4, at 78-88.
109 Daniel L. Rubinfeld & Suzanne Scotchmer, Contingent Fees for Attorneys: An Economic Analysis, 24 RAND
110 Kritzer, Seven Myths, supra note 2, at 757-61.
111 See Kritzer, Risks, supra note 2, at 42-43. For additional data, see Brickman, supra note 14, at 657 n.11.
112 See, e.g., Brickman, supra note 3, at 102 (“The failure of contingent fees adequately to reflect risk is an
indication that the free market mechanism for regulation of competition is not working”); Painter, supra note 22,
at 657-59 (arguing that in a competitive market the CF should vary based on the size of the claim, the risk it
involves, the time devoted to the case, and the attorney’s skill).
113 See supra notes 101-102 and accompanying text.
114 Brickman, supra note 4, at 91-92 (arguing that CF rates in the United States “have varied neither on the basis
of competitive pressures nor on the likelihood of success in each case, but on the notion of what lawyers have
felt comfortable charging within the confines of a judicial regulatory mechanism that essentially capped
contingent fees at 50 percent”); Brickman, supra note 3, at 106-07.
uniform rates imply that some plaintiffs cross-subsidize other plaintiffs, and attorneys as a group charge supra-competitive fees.

Another hypothesis is that the costs of evaluating the strength of any case ex ante are so high that the parties simply cannot bargain over the CF rate in a meaningful way. While having some merit, we would not ascribe too much import to this explanation. Lawyers regularly assess the strength and value of cases when they decide whether to accept a case; they often decline cases based on a lack of perceived liability or inadequate damages.\footnote{Kritzer, Seven Myths, supra note 2, at 756. As Kritzer indicates (id., at 754-57), while rejection rate varies, most lawyers turn down most callers. On lawyers’ screening policies, see also infra note 144 and accompanying text.} It is unlikely that experienced lawyers can make such assessments for the purpose of deciding whether to take a case, but are unable to make them for the sake of setting CF rates. Even if information problems make it impossible to fine-tune CF rates to the precise percentage appropriate, they do not prevent lawyers from appraising their rates more roughly, using, for instance, a ten- or twenty-grade scale (that is, setting the CF rate as 10, 20, 30, …, or 5, 10, 15, … percent of recovery).

While Brickman’s explanation, coupled with our analysis of the fairness constraint on pricing, reasonably explain why CF rates do not exceed certain limits, neither Brickman’s analysis nor our discussion accounts for the distinctive uniformity of CF rates. In what follows, we shall address this phenomenon from a behavioral and economic perspective.

B. PSYCHOLOGY AND ECONOMICS: FOCAL POINTS, STATUS QUO BIAS,
AND ASSORTATIVE MATCHING

To understand the uniformity of CF rates, and in particular the prevalent rate of 1/3 of the recovery, one must explain three related phenomena. First, why it is that the common flat rate is 1/3 (and in the variable percentage cases, the common pattern is a scale of rates of 1/4, 1/3 and 2/5 or 1/2, depending on the stage to which the case gets)? Second, one has to account for the fact that people are very reluctant to deviate from the standard rate. Third, we need to understand how a uniform rate comports with the basic rules of supply and demand in the heterogeneous market for legal services. Without necessarily discarding alternative explanations focusing on the incentives created by CF arrangements,\footnote{Wang, The Optimality of Contingent Fees in the Agency Problem of Litigation (March 2007, Available at SSRN: http://ssrn.com/abstract=1017798), argues that CF with a fixed rate across many different cases is optimal. However, his model assumes that when the plaintiff and lawyer contract, it is certain that the costs of handling the case will be lower than recovery, that the lawyer’s effort and the prospects of winning the case are positively correlated, and that a certain level of effort secures the winning of} we suggest that the

\footnote{In a recent working paper (The Optimality of Contingent Fees in the Agency Problem of Litigation (March 2007, Available at SSRN: http://ssrn.com/abstract=1017798), Susheng Wang argues that CF with a fixed rate across many different cases is optimal. However, his model assumes that when the plaintiff and lawyer contract, it is certain that the costs of handling the case will be lower than recovery, that the lawyer’s effort and the prospects of winning the case are positively correlated, and that a certain level of effort secures the winning of
notion of focal points in bargaining may help elucidate the first issue, that the notions of reference points and Status Quo Bias help clarify the second, and that the solution to the third puzzle plausibly lies in assortative matching.

Focal Points. A focal point is a particular point, often along a continuum (of prices, allocations and the like) that stands out as natural, conspicuous, or otherwise special, thus facilitating coordination between people who do not communicate with each other, as well as affecting the outcomes of explicit bargaining.\textsuperscript{117} Thus, for example, studies of crop-sharing contracts around the world reveal a very high degree of uniformity, the most popular shares being 1/2:1/2 and 1/3:2/3.\textsuperscript{118} As Thomas Schelling observed, “[i]n bargains that involve numerical magnitudes… there seems to be a strong magnetism in mathematical simplicity. A trivial illustration is the tendency for the outcomes to be expressed in ‘round numbers.’”\textsuperscript{119}

This tendency explains the use of fractions with small denominators. Bargaining experiments have shown that when a single focal point exists, the prospects of reaching an agreement are clearly higher than when there is more than one focal point or no focal points at all.\textsuperscript{120} In the present context, the existence of a dominant focal point in flat fee arrangements (the CF rate of 33%) is particularly conducive to reaching an agreement between the parties. The theory of focal points does not explain why the prevailing CF rate is 1/3 rather than, for instance, 1/2 or 1/4. The answer to this question plausibly lies in ordinary economic factors, such as supply and demand.

Status Quo Bias and Related Phenomena: Absent regulation of CF rates, the prevailing rate (which constitutes a trade usage) may be seen as a mere precedent. However, as Schelling observed, “[p]recedent seems to exercise an influence that greatly exceeds its

the case. Since in reality these assumptions do not ordinarily hold (and even if they do, the plaintiff may not know it), this argument is not very helpful.

\textsuperscript{117} The notion of focal points was introduced in THOMAS C. SCHELLING, THE STRATEGY OF CONFLICT (1960). While Schelling’s primary concern was coordination without communication, he also discussed the role of focal points in explicit bargaining (id., at 67-74). For a brief summary of game theory studies of focal points, see MAARTEN C.W. JANSEN, FOCAL POINTS, in 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 150 (Peter Newman, ed., 1998). For a lucid description of the theory and an argument concerning the role of law in creating focal points that facilitate coordination, see RICHARD H. McADAMS, A FOCAL POINT THEORY OF EXPRESSIVE LAW, 86 VA. L. REV. 1649 (2000).

\textsuperscript{118} See, e.g., JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY 302-203 (1848, Longman, Green & Co., 1929) (describing customary crop-sharing arrangements in Italy and France); H. PÉYTON YOUNG & MARY A. BURKE, COMPETITION AND CUSTOM IN ECONOMIC CONTRACTS: A CASE STUDY OF ILLINOIS AGRICULTURE, 91 AM. ECON. REV. 559 (2001) (surveying previous studies and discussing the prevalent arrangements in Illinois).

\textsuperscript{119} SCHELLING, supra note 117, at 67.

logical importance or legal force.” ¹²¹ Numerous economic and behavioral explanations have been offered for the inclination of contracting parties not to deviate from default rules and trade usages.¹²² The most basic explanation is that contracting around a default involves costs. In the present context, the primary costs to be considered are not the direct ones of negotiating and formulating the fee term, but rather the indirect ones: the effect of such negotiation on the parties’ relations.¹²³ Trade usages and bargaining norms are a form of “social capital” in the sense that they facilitate coordination and increase the chances of successful bargaining.¹²⁴ The reduction of confrontations in bargaining is particularly important in relational contracts.¹²⁵ Contrary to discrete, transactional contracts (such as the sale of a used car by a private owner to a stranger), in client-attorney relationships the establishment of cooperation, confidence and trust is crucial. The negotiation and contracting stages in such relational contracts focus more on structuring the procedures for cooperation than on the substance of exchange.¹²⁶ Both parties typically prefer to discuss as little as possible (or even not discuss at all) the conflictual aspects of their relationships, including, in particular, the lawyer’s fee.¹²⁷ The existence of a known standard fee in the market enables the parties to avoid haggling about the fee, and at the same time their reluctance to discuss this issue guarantees that the standard endures.

Prevailing norms, such as the standard CF rate, not only reflect people’s preferences but also shape them.¹²⁸ People tend to assume that the prevailing rate is reasonable, balanced and just. As explained above, they treat the common fee as a benchmark for judging fairness.¹²⁹

¹²¹ SHELLING, supra note 117, at 67.
¹²³ On the direct, and particularly the indirect, costs involved in contracting around default rules and trade usages, see Zamir, supra note 122, at 1755-58; Korobkin, Status Quo, supra note 122, at 621.
¹²⁴ See YOUNG, supra note 120, at 115.
¹²⁵ Lisa Bernstein, Social Norms and Default Rules analysis, 3 S. CAL. INTERDISC. L.J. 59, 70 (1993) (arguing that relational factors increase the costs of contracting around default rules).
¹²⁶ For a classic, insightful analysis of the sociological differences between relational contracts and discrete transactions, see Ian R. Macneil, The Many Futures of Contracts, 47 S. CAL. L. REV. 691 (1974). On the dissimilar contracting processes characterizing the two paradigms, see id., at 753-80.
¹²⁷ In Kritzer’s survey, 25% of the individual clients and 33% of the organizational ones reported that fees were not discussed at all with the lawyer prior to receiving the bill. Kritzer, Justice Broker, supra note 2, at 57. See also RICHARD L. ABEL, AMERICAN LAWYERS 27 (1989) (alluding to “the widespread convention that lawyers and physicians do not discuss fees in advance”).
¹²⁹ See supra notes 89-91 and accompanying text.
They feel secure knowing that their agreement conforms to the prevailing usage.\textsuperscript{130} The more widespread the adherence to a background norm, the likelier it is that a suggestion to deviate from it will arouse the suspicion of the other party regarding its hidden motives.\textsuperscript{131}

In addition to shaping people’s preferences, prevailing norms also produce an \textit{endowment effect} and create a \textit{status quo bias}.\textsuperscript{132} As an abundance of empirical research has shown, people attribute greater value to entitlements they already have than to entitlements they have to acquire. This phenomenon is sometimes called the \textit{offer-asking problem}, because people typically ask a much higher price to part with an entitlement they already have than they are willing to offer to acquire the same entitlement, if they do not have it. This phenomenon is particularly manifest when people face choices involving risk or uncertainty, such as exchanging lottery tickets or exposing themselves to a low probability risk of a considerable loss (people are unwilling to pay much to avoid such an existing risk, but ask for very large sums to voluntarily expose themselves to the risk).\textsuperscript{133} Some instances of the endowment effect may possibly be explained on the basis of the wealth effect of having an entitlement.\textsuperscript{134} More general and compelling inter-related behavioral explanations rest on such notions as loss aversion (discussed above), regret avoidance,\textsuperscript{135} the power of inertia, and the different perceptions of outcomes resulting from action and inaction.\textsuperscript{136}

Arguably, default rules and trade usages, such as the prevailing CF rate, cannot create an endowment effect, because none of the parties has an entitlement under such norms unless and until someone else is willing to contract with her under terms compatible with these

\begin{quote}


\textsuperscript{132} The effect of default rules and usages on people’s preferences and the creation of an endowment effect/status quo bias are related but different phenomena. It is possible, for example, that a person’s preferences are shaped by the norms prevailing in one environment, yet she is bargaining against the backdrop of a different set of norms, possibly because she has moved from one place to another. The new environment may endow that person with lesser or greater entitlements, and thus create an immediate endowment effect despite the fact that her personal preferences are different. See Zamir, supra note 122, at 1762.


\textsuperscript{134} According to the rule of diminishing marginal utility, a poorer person (the one without the entitlement) is able to allocate a smaller sum to purchase the entitlement, and thus “values” it less. This explanation is however applicable only where the entitlement constitutes such a large portion of a person’s assets to significantly affect her wealth—which is very rarely the case.


\end{quote}
norms. However, as both daily experience and controlled experiments reveal, people do conceive of such general norms as a backdrop against which they bargain. Bargaining is never done in a legal or social vacuum. When a negotiating party tries to contract around an established norm known to both parties, such as the standard CF rate, the other party may well feel that she is asked to part with something she “already has.”

In the present context, a deviation from the standard CF rate does not merely change the division of the surplus; it also involves risk. Agreeing on a CF rate that is lower or higher than the standard rate may result in a net recovery for the plaintiff that is either higher or lower than under the standard rate. This is because the CF rate affects not only the parties’ shares of the recovery, but presumably also its size: the higher the rate, the stronger the lawyer’s incentive to invest in handling the case. This risk is likely to reinforce the status quo bias.

To sum up, the cumulative effect of (1) the costs of contracting around the standard CF rate—particularly the indirect costs stemming from the distinctively relational nature of the lawyer-client contract, (2) the effect of the standard rate on people’s conceptions and preferences, and (3) the endowment effect created by the prevalent norm, powerfully hinders deviations from the prevailing rate.

**Assortative Matching.** Focal points, including those created by precedents, are obviously not the only factor determining the content of agreements. As the data reveals, while the standard rate of 33% is very common, it is not invariably adhered to. Sometimes the parties find it worthwhile to deviate from the standard rate, which presumably means that such factors as the expected recovery and expected work do play a role. For the focal point of 33% to endure (as it does) in even a relatively competitive market, it must not be far removed from the economically efficient allocation in most cases. This may well be the case thanks to a process of assortative matching.

Had all lawyers possessed the same qualities, one would have expected that plaintiffs with particularly strong cases, that is cases with very high expected value, could insist on lower-than-standard CF rates, and plaintiffs with particularly weak cases would have to pay higher

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139 See *supra* notes 110-111 and accompanying text.

140 Cf. Young & Burke, *supra* note 118, at 562-63 (pointing out that while crop-sharing agreements in Illinois are strongly affected by focal points, focal points are not the only factor that matters, and economic fundamentals, such as the quality of land, matter too).
contingency fee. Similarly, were all cases alike, one would have expected outstanding lawyers to charge higher-than-standard CF (which may still leave the plaintiff with a larger net recovery), and lesser lawyers to charge lower rates. In a market where both cases and lawyers are heterogeneous and in which (as we have just seen and as described in Part II above) various factors inhibit deviations from the standard rate, setting the fee as a certain share of recovery facilitates a process of assortative matching that makes the uniform rate economically viable. In this process, plaintiffs with particularly strong cases seek lawyers of particularly high repute; and lawyers of high repute reject all but the very best cases. In such a match, the “high quality” of the case is likely to result in an especially large fee for the lawyer, and the quality of legal services is expected to result in a particularly large net recovery for the plaintiff, without deviating from the standard CF rate. As “top plaintiffs” are unlikely to hire second-best lawyers, and top lawyers are unlikely to take “second-best cases,” the “second best” are expected to match with each other, and so forth. If such matching between the quality of cases and quality of legal services roughly exists in the market, and given the obstacles to deviating from the prevailing CF rate, the incentives for plaintiffs and lawyers to depart from the standard CF may be limited.

Empirical support for the hypothesis of assortative matching is provided by a large-scale study of Texas plaintiff lawyers conducted by Stephen Daniels and Joanne Martin. Daniels and Martin describe a hierarchical plaintiff bar. The “Bread and Butter” lawyers at the bottom of this hierarchy ordinarily deal with low-value cases, while the “Heavy Hitters” at the top handle very large ones. These categories, as well as the intermediate categories, differ not only with regard to the mean value of the cases they handle (the mean and median cases ranging from several thousands dollars to several millions), but also regarding the scope of the geographic market they serve (local, regional, or state/national), the sources of their cases (that is, the percentage of clients coming from other lawyers’ referrals, referrals from other clients, advertisements, and so forth), and the percentage of callers they turn down. While the lawyers at the bottom of the ladder get 20% of their clients through advertisements and 20% through other lawyers’ referrals, those at the top get only 6.9% of the clients through advertisements and 55.3% through referrals from other lawyers. These findings imply that

141 The notion of assortative matching was first introduced and analyzed from an economic perspective by Gary Becker. See Gary S. Becker, A Theory of Marriage: Part I, 81 J. POLITICAL ECON. 813 (1973).
142 The outcomes of any claim depend not only on the facts and circumstances giving rise to it, but also on the quality of representation, and in that sense the strength of a case and the expertise of the attorney are interrelated. However, in the present context our focus is on those aspects of the claim that do not depend on the legal representation.
143 Stephen Daniels & Joanne Martin, It Was the Best of Times, It Was the Worst of Times: The Precarious Nature of Plaintiffs’ in Texas, 80 TEX. L. REV. 1781, 1783-95 (2002).
low value plaintiffs spend less time and effort in seeking an attorney. This is even more
evident when comparing the geographic markets. While 81.7% of those at the bottom of the
hierarchy describe their market as local and merely 1.5% as state/national, only 32.4% of the
top lawyers describe their market as local, and 38.8% as state/national. Plaintiffs with high-
value claims are thus willing to travel long distances to get better representation. As for the
screening policy, whilst lawyers at the bottom category sign a CF contract with 35.1% of the
potential clients (the median being 30%), those at the top contract with only 17.9% of the
callers (with a median of 10%). Empirical studies of the referral practices among lawyers
indicate that, although attorney referral plays a greater role in the practice of high-end
lawyers, the latter also refer low-value cases to low-end lawyers. The referral mechanism
compensates for clients’ typical lack of knowledge of lawyers’ expertise and quality.

Even if the process of assortative matching is partial and imperfect—as it must be—it may
be effective enough to counterbalance the incentives of strong plaintiffs and successful
lawyers to deviate from the standard CF rate. If this is the case, than the ex ante cross-
subsidization between different clients of the same attorney probably exists, but is less
dramatic than it would have been absent the assortative matching process.

Policy Implications. Inasmuch as our analysis captures the realities of the market for legal
services, it implies that the manifest uniformity of CF rates does not necessarily stem from
such market failures as plaintiffs’ acute information problems or collusion among plaintiff
lawyers who tacitly agree not to compete over fees. If the present uniformity stems, to a large
extent, from such phenomena as focal points in bargaining, status quo bias and assortative

144 Id. Support for this pattern is provided by an empirical research indicating that while “low-end” practitioners
who handle personal injuries in Chicago take 49% of the cases they screen, “high-end” (the top 19%) and “elite”
(top 1%) practitioners take 36% and 24% respectively. See Sara Parikh, Professionalism and Its Discontents: A
Study of Social Networks in the Plaintiff’s Personal Injury Bar, Unpublished Ph.D. dissertation, University of
Illinois at Chicago 75-78 (2001) (on file with authors).
145 See Sara Parikh, How the Spider Catches the Fly: Referral Networks in the Plaintiffs’ Personal Injury Bar, 51
N.Y.L. SCH. L. REV. 243, 248 (2006/7) (“Low-end personal injury lawyers often refer higher-value cases up the
hierarchy. In turn, high-end practitioners refer low-value cases back down”). See also id., at 254 (“For attorneys
in the low-end sector, about one-third of their business comes from other attorneys. By contrast, attorney referral
generates about two-thirds of the business for attorneys in the high-end and elite sectors”); Stephen J. Spurr,
Referral Practices Among Lawyers: A Theoretical and Empirical Analysis, 13 LAW & SOC. INQUIRY 87, 94
(1988) (finding that in his sample, high-quality lawyers obtain 52% of their cases by referral from other lawyers,
whereas the average lawyer gets only 27% of the cases in this way); Stephen Daniels & Joanne Martin, “It’s
Darwinism – Survival of the Fittest:” How Markets and Reputations Shape the Ways in which Plaintiffs’
146 Parikh, supra note 145, at 252, 257 (stating, on the basis of a large-scale empirical study, that “[w]hile
consumers are believed to have imperfect information about different attorneys in a jurisdiction, attorneys
themselves are said to be more knowledgeable about the quality and capabilities of their peers”); Spurr, supra
note 145, at 92.
matching, then it would take more than the existence of the standardization of fees to justify regulating lawyers’ fees.

IV. WHY DO DEFENDANTS NOT USE CONTINGENT FEES?

A. THE PUZZLE AND PROPOSED SOLUTIONS

Thus far, our discussion revolved around plaintiffs’ recourse to CF arrangements and the characteristics of this market. In principle, contingency fees may be used by defendants just as they are used by plaintiffs. Once a suit is filed, the defendant and her attorney could agree that the attorney’s fee will be a certain percentage of that part of the claim that will be dismissed. For instance, a defendant who is sued for $100,000 may agree to pay her attorney one third of the difference between this sum and the sum she will have to pay the plaintiff. In this example, if the plaintiff will be awarded, say, $70,000 in damages, the defendant will pay her attorney a fee of $10,000 (one third of $30,000), and no fee if the plaintiff will be awarded $100,000. However, while CF arrangements are prevalent among plaintiffs’ attorneys, they are quite rare among defendants’ lawyers.147 This “paradoxical behavior” is puzzling because many of the explanations for the use of CF apply equally to both plaintiffs and defendants.148 CF removes the risk that the defendant will have to pay both the full amount of the claim and her attorney’s full fixed or hourly fee. Hence, risk-averse defendants should presumably prefer CF just as risk-averse plaintiffs do. Similarly, just as CF mitigates the incentive problem of plaintiffs’ attorneys, it can mitigate the same problem for defendants’ lawyers.149 While an attorney paid by the hour may spend too much time and effort defending a lawsuit when the prospects of successful defense are slim, an attorney paid on a CF basis would refrain from such a waste of time and advise her client to settle the case or even pay the entire claim (that is, refuse to take the case).

Several explanations have been offered for this puzzle. First, CF on the defendant’s side is more difficult to calculate and administer. Presumably, the sum of money recovered by a

147 See, e.g., Robert E. Litan & Steven C. Salop, Reforming the Lawyer-Client Relationship through Alternative Billing Methods, 77 Judicature 191, 195 (1994) (“Contingent fee arrangements for defendant’s counsel… appeared to be used infrequently”). According to the information provided by the tort lawyers who participated in Experiment 1, while they charge on a CF basis in 90% of the cases in which they represent plaintiffs, only 30% of them, in an average professional career of 15 years, have ever represented a defendant on this basis. For a survey of cases discussing defendants’ CF arrangements, see Romualdo P. Eclavea, Annotation, Validity, Construction, and Effect of Contract Providing for Contingent Fee to Defendant’s Attorney, 9 A.L.R. 4th 191 (1981).


149 Id., id.
plaintiff reasonably reflects the merit of her case and may thus serve as a basis for calculating the CF. In contrast, the sum claimed by a plaintiff may reflect strategic considerations and is therefore an unsafe basis for determining the “savings” to the defendant due to her attorney’s skill and efforts. When a claim has a substantial component of ‘general damages,’ such damages may not even be specified by the plaintiff. Also, since plaintiffs’ attorneys may deduct their fee from the damages paid by the defendant, and thus have an effective means of collecting their fees, they can give their clients credit through CF at a relatively low cost. In contrast, defendants’ attorneys enjoy no such means and may thus be more reluctant to extend credit through CF.

Other explanations for the relative rarity of CF use by defendants focus on the characteristic differences between plaintiffs and defendants, especially in personal injury cases. Defendants are often large firms or insurance companies. Unlike poor plaintiffs, they neither need the credit CF attorneys afford their clients, nor the risk-sharing element of CF. Furthermore, as sophisticated, repeat players, defendants are better positioned to assess the merits of cases brought against them. Hence, while CF can efficiently cope with plaintiffs’ inability to evaluate the merit and value of their claims (because CF guarantees that the attorney will take a case only if it is worthwhile to pursue), such means is arguably unnecessary on the defendants’ side. Finally, large firms can more effectively monitor the activities of their attorneys, and are therefore less vulnerable to the conflict of interests inherent in fixed or hourly fees. Lawyers who wish to maintain profitable relationships with large defendant firms have strong incentives to act in the best interests of their clients.

Some of these explanations, however, rest on questionable generalizations, and none of them account for the entire picture. A conspicuous difficulty of the explanations resting on the typical differences between plaintiffs and defendants is that even large firms use CF when hiring attorneys as plaintiffs in tort actions and for collecting commercial and retail

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150 RICHARD EPSTEIN, CASES AND MATERIALS ON TORTS 804 (2004); Danzon, supra note 77, at 223; Dana & Spier, supra note 148, at 363.
151 Arguably, this means of collection also makes the payment of the attorney’s fee less “painful.” Cf. George Lowenstein & Ted O’Donoghue, “We Can Do This the Easy Way or the Hard Way”: Negative Emotions, Self-Regulation, and the Law, 73 U. CHI. L. REV. 183, 199 (2006) (pointing out that income tax with withholding is less salient, and hence less painful, than requiring people to write a check to the government). This phenomenon, to the extent it exists, may also be explained according to prospect theory, because it is easier for the plaintiff not to accept the attorney’s share in the first place, than getting the entire award and then having to part with large share of it. Dana & Spier, supra note 148, at 363-64; Danzon, supra note 77, at 223.
152 Dana & Spier, supra note 148, at 364.
153 Dana & Spier, supra note 148, at 364. See also Rickman, supra note 1, at 38 (arguing that organizations’ better monitoring capability accounts for the fact that plaintiffs who are individuals resort to CF much more than plaintiffs who are organizations).
accounts. At the same time, even unwealthy, unsophisticated and risk-averse defendants do not commonly use CF. As for the asymmetric information and monitoring costs, even a large commercial defendant is unlikely to possess the professional expertise of its attorneys. The asymmetric information and agency problems explaining the prevalence of CF on the plaintiffs’ side are therefore applicable to defendants as well. In the same vein, the alleged collection difficulties of CF by successful defendant attorneys may be overcome quite easily by prepayment arrangements, subject to the possibility of repayment by the attorney. Finally, while it is true that the sum claimed by a plaintiff may be inflated, the defendant and her attorney may agree that the benchmark for calculating CF would be a lower sum. A parallel argument is made regarding CF for plaintiffs, namely that often the appropriate benchmark for calculating the attorney’s CF should be higher than zero as it is clear that even absent any effort by the lawyer, the defendant will offer—or even already offered—some positive payment to settle the case.

It is not our goal to undermine or discard the above explanations for the plaintiffs/defendants puzzle. Rather, we propose a more general explanation, which complements the existing ones. Our explanation draws on prospect theory, described in Section I.B.1 above, and on an experiment we conducted to investigate the issue. The following Section describes our experiment, and the last Section of this Part discusses its implications.

B. EXPERIMENT 5: PLAINTIFFS AND DEFENDANTS

This experiment was designed to test whether the preference for CF over FF depends on the role of the decision maker as a plaintiff or as a defendant. By keeping all aspects of the case and the fee arrangement options constant—varying only the role of the decision maker—we can determine to what extent his or her preferences are affected by the role played. As defendants are more likely than plaintiffs to frame both the CF and the FF outcomes as pure losses, we expected the CF arrangement to lose its unique appeal when the options are considered from a defendant’s perspective. Hence we predicted a preference reversal, whereby CF will be preferred over FF when participants respond as plaintiffs, and FF will be more attractive when participants respond as defendants.

Participants. 77 students (35 females, 42 males) responded to the questionnaire in exchange for 10 NIS. Their ages ranged between 19 and 30, with a mean of 24.

Experimental Design. We employed six decision problems for which respondents were asked to indicate whether they preferred the CF or the FF arrangement. As in previous choice experiments, they were also given the option to avoid taking any legal action. The numerical details for the six problems are presented in Table 9. Again, the problems varied in the expected award, the probability of winning and the CF rate. The type of damage (property or personal) was not indicated. The CF was set so that the expected CF would be approximately twice as high as the FF. The three questions were presented twice in each questionnaire: one time as a scenario involving a plaintiff, and a second time as a similar scenario involving a defendant. The order of plaintiff/defendant framing of the problem, as well as the order of the problems and the order of the CF and FF options, were counterbalanced across subjects.

<table>
<thead>
<tr>
<th>Case</th>
<th>Damage</th>
<th>Prob.</th>
<th>EV</th>
<th>%CF</th>
<th>ECF</th>
<th>FF</th>
</tr>
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<tr>
<td>1</td>
<td>100,000</td>
<td>.90</td>
<td>90,000</td>
<td>25</td>
<td>22,500</td>
<td>11,000</td>
</tr>
<tr>
<td>2</td>
<td>150,000</td>
<td>.80</td>
<td>120,000</td>
<td>30</td>
<td>36,000</td>
<td>18,000</td>
</tr>
<tr>
<td>3</td>
<td>60,000</td>
<td>.95</td>
<td>57,000</td>
<td>35</td>
<td>19,950</td>
<td>10,000</td>
</tr>
</tbody>
</table>
The plaintiff scenarios were similar to the ones used in Experiments 1 and 2. A typical defendant scenario read as follows:

Imagine that a suit was filed against you for damages of 100,000 NIS for harm caused to the plaintiff, that he claims you are liable for. A jurist friend estimates that if you will defend against the suit, there is a 90% chance that the suit will be dismissed, and you will not have to pay the plaintiff anything.

You may choose one of the following three options:

A. Ask a lawyer to represent you in the legal proceedings for a fee of 25% of the sum you will save as a result of the dismissal of the claim (if the suit will be dismissed and you will not have to pay the plaintiff anything, you will pay your lawyer 25,000 NIS, and if you will be obliged to pay the damages, you will not pay your lawyer any fee). Assume that the lawyer bears all the costs involved in the legal proceedings.

B. Ask a lawyer to represent you for a fixed sum of 11,000 NIS (that you’ll have to pay him even if you will be obliged to pay the damages of 100,000 NIS). Assume that the lawyer bears all the costs involved in the legal proceedings.

C. Pay the damages of 100,000 NIS.

What option would you prefer? (Circle the appropriate answer) A   B   C

Results. The percents of CF and FF choices for each case are presented in Table 10, separately for choices made in the defendant and in the plaintiff roles. We computed for each case the percent of CF choices out of all choices made in the defendant role, excluding the avoidance choices, and the corresponding percent for choices made in the plaintiff role. Across all orders, participants preferred CF over FF in 57% of the three cases in which they acted as plaintiffs (out of non-avoidance choices), and in only 29% of the three cases in which they acted as defendants.\(^{160}\)

\(^{160}\) F(1,73)=32.13, p<.001, in a repeated measure ANOVA with percent CF choices in the two roles as a within-subject dependant factor, and the two order factors as between-subject independent predictors.
Table 10
Percent of CF choices, out of all non-avoidance choices, N=77

<table>
<thead>
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<tr>
<td>Plaintiff</td>
<td>CF</td>
<td>67.5</td>
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</tr>
<tr>
<td></td>
<td>FF</td>
<td>32.5</td>
<td>23.4</td>
</tr>
<tr>
<td>Defendant</td>
<td>CF</td>
<td>29.9</td>
<td>36.4</td>
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<tr>
<td></td>
<td>FF</td>
<td>68.8</td>
<td>61.0</td>
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</table>

C. ANALYSIS AND IMPLICATIONS

Our experiment demonstrates that even in the absence of any of the typical differences between plaintiffs and defendants—their affluence, risk-aversion, sophistication, being one-shot or repeat players, means of collecting attorney’s fee, or the ease of calculating the fee—people display very different preferences regarding the choice between CF and FF when they are positioned in the different roles of plaintiffs and defendants. While a clear majority of plaintiffs (57%) preferred CF over FF when the ratio between FF and the expected CF was approximately 1:2, when acting as defendants, more than two thirds (71%) preferred FF over CF under similar conditions. The fact that the same people were asked to make the choice as both plaintiffs and defendants excludes any explanation having to do with differences between subjects.

The results of our experiment are perfectly compatible with prospect theory, and in particular with the characterization of people as risk averse in the domain of gains (that is, when they act as plaintiffs) and as risk seeking in the domain of losses (that is, when they act as defendants). For the defendant, FF implies that she will have to pay a total sum ranging from the fixed fee only (if the claim is fully dismissed) to the claimed sum plus the FF (if the plaintiff gets her entire claim). CF, in contrast, narrows this range and thus reduces the defendant’s risk. Under CF, while the minimal loss may be higher than under FF, the maximal loss is capped by the claimed sum, because if the claim is fully successful, the defendant’s attorney gets no fee. Thus, rational choice theory, which views the choice between CF and other fee arrangements as basically similar for plaintiffs and defendants, crucially misses the different ways plaintiffs and defendants frame this choice. Possibly, the fact that all respondents were presented with both the plaintiff and the defendant scenarios, with the same

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The numbers do not add up to 100 because of the third option, namely to abstain from taking any legal measures.
numerical details in both framings, highlighted the similarity between the situations and thus reduced the framing effect.\footnote{162}

Arguably, a plaintiff who suffered injury or loss in an accident may view her pre-accident position as the pertinent reference point, and thus view even positive recovery as a loss (as long as the recovery is smaller than her losses).\footnote{163} Likewise, a defendant who profited from violating the plaintiff’s rights may view even a judgment or a settlement requiring her to pay a certain amount of money as decreasing her gains rather than as involving a loss. However, such framings are unlikely to occur in most cases.\footnote{164} First, studies have indicated that people internalize losses and gains and adapt their reference points rather quickly.\footnote{165} Thus, by the time the plaintiff or defendant has to choose a fee arrangement, the plaintiff is likely to view the reward as a gain, and the defendant as a loss.\footnote{166} Second, death, personal injury and comparable claims often include a substantial component of damages for non-monetary

\footnote{162 In another experiment, the subjects were presented with choices between monetary gambles. Three out of four framings resembled the plaintiff’s position, and one the defendants’ position, and each subject was presented with only one type of framing. Whereas in the mixed v. pure positive gambles, 73% to 88% of the subjects opted for the pure positive gamble, only 17% of the subjects opted for the corresponding option in the pure loss framing. See Ritov & Zamir, supra note 72.

163 Russel Korobkin & Chris Guthrie, Psychology, Economics, and Settlement: A New Look on the Role of the Lawyer, 76 Tex. L. Rev. 77, 95-99 (1997). In fact, it was demonstrated that plaintiffs’ framing of settlement offers may be manipulated to be framed as either gains or losses. See Russell Korobkin & Chris Guthrie, Psychological Barriers to Litigation Settlement: An Experimental Approach, 93 Mich. L. Rev. 107, 120-42 (1994).

164 For the claim that, as a general matter, plaintiffs frame decisions associated with litigation as belonging to the domain of gains, while defendants frame such decisions as belonging to the domain of losses, see Rachlinski, supra note 8, at 128-30 (discussing the framing of settlement decisions). For further theoretical and experimental support of this claim, see, e.g., ROBIN HOGARTH, JUDGMENT AND CHOICE 105 (2d ed. 1987) (arguing that the role of plaintiff implies a frame of gains and the frame of defendant a frame of losses); Linda Babcock, Henry S. Farber, Cynthia Fobian & Eldar Shafir, Forming Beliefs about Adjudicated Outcomes: Perceptions of Risk and Reservation Values, 15 Int’l Rev. L. & Econ. 289 (1995) (describing the framing of statements of “reservation-price” for settlement by subjects situated as either plaintiffs or defendants); Guthrie, supra note 8, at 182 (“Scholars have found ample evidence in experimental settings demonstrating that plaintiffs facing moderate-to-high probability gains and defendants facing moderate-to-high probability losses exhibit risk-averse and risk-seeking behavior respectively”); Chris Guthrie, Prospect Theory, Risk Preference, and the Law, 97 Nw. U.L. Rev. 1115 (2003) (reviewing the literature); Peter J. van Koppen, Risk Taking in Civil Law Negotiations, 14 Law & Hum. Behav. 151 (1990) (providing inconclusive experimental support for the proposition that plaintiffs are risk averse and defendants risk seeking); Note, Risk-Preference Asymmetries in Class Action Litigation, 119 Harv. L. Rev. 587 (2005).


166 Rachlinski, supra note 8, at 129 n.65. The fact that in our experiments subjects were informed about their loss or injury at the same time in which they were asked to make the choice of fee arrangement—rather than at a later point in time—perhaps explains why the preference for CF in our experiments was weaker than in the real world. Possibly, some of the subjects who acted as plaintiffs in our experiments framed both options as belonging to the domain of losses, and thus acted as risk-seekers. This conjecture complements the other possible explanations for this gap, discussed in the text accompanying supra notes 80-81.}
injuries. In such cases, damages are likely to put the plaintiff in a better monetary position even compared to her pre-accident positions. The same is certainly true with regard to punitive damages, which are not meant to compensate the plaintiff for any loss she has suffered. In line with previous experimental results, our findings strengthen the conclusion that defendants indeed view litigation as a pure negative gamble, while plaintiffs view it as a pure positive or a mixed gamble, depending on the fee arrangement.

Admittedly, the gap between the expressed preferences for CF under the two conditions in Experiment 5 is smaller than the difference between the actual behavior of plaintiffs and defendants in this respect in the real world. In addition to the fact that our respondents were faced with the two types of framings in the same questionnaire, this difference plausibly indicates that the factors discussed in Section IV.A above also impact CF preferences.

CONCLUSION

People’s preferences, judgments and choices play a central role in the market for legal services, as they do in any sphere of human behavior. Past scholarship analyzed this market from legal, comparative, ethical, economic, political-economic and sociological perspectives, yet curiously disregarded its behavioral aspects. As this Article demonstrated, cognitive psychology in general—and prospect theory in particular—can greatly contribute to a better understanding of the particular characteristics of this market and to a resolution of some of the major descriptive and normative debates surrounding it. Inter alia, our findings and analysis shed new light on the role of loss aversion in people’s choice of CF arrangements; the extent of people’s preference for such arrangements; the (rather limited) weight clients attribute to incentivizing the lawyer in their choice of fee arrangements; the (again limited) role of information problems and lack of options in the market; the causes for the uniformity of CF rates, the prevalence of “round” rates (such as one-third or one-fourth of recovery) and their puzzling stability over long periods of time; and the rarity of CF use by defendants.

We do not argue that the behavioral perspective is necessarily more important than other points of view. Hence our analysis incorporated numerous insights from other brands of scholarship. We are also aware of the limits of experimental studies of the kind presented in the Article. We do, however, believe that behavioral factors play a key role in the contingency

167 Rachlinski, supra note 8, at 128-29.
168 Further support for the assumption that plaintiffs view the prospects of their claim as belonging to the domain of gains may be found in the gamble experiment described in Ritov & Zamir (supra note 72), which manipulated the gambles in ways corresponding to different possible framing of the plaintiff’s choice.
fee market and that the experimental results provide strong evidence about these factors. Our results also illuminate other contexts in which people face comparable choices.

The picture emerging from our research is sharper than previous ones, but not at all simpler. Contrary to some depictions of the CF market, we conclude that lawyers are neither saints nor devils. The positive and normative picture is rather complex and nuanced; so should be the legal treatment of contingent fee arrangements.