
**LEGAL FEE RESTRICTIONS, MORAL
HAZARD, AND ATTORNEY PROFITS**
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pending or contemplated lawsuit. These rules effectively set a minimum value of zero for the fixed fee, precluding the purchase of legal claims.

Various explanations have been given for these fee restrictions. One view, supported by Marc Shukaitis,¹ is that the restrictions are historical relics that are unnecessary and inefficient in the modern legal environment. Other authors have argued informally that the restrictions play an anticompetitive role.² However, given that attorneys remain free to compete along the contingent-fee dimension, it is not obvious that competition is harmed by the nonnegativity constraint on fixed fees. Despite the lack of formal justification, numerous courts and state bar associations have acknowledged the anticompetitive purpose of the restrictions.³

We provide a political economy explanation for the restrictions, arguing that they benefit attorneys while harming clients. In particular, we show that the restrictions on negative fixed fees, like other forms of price-fixing, can function as anticompetitive devices. When the fixed costs of litigation are low, these restrictions allow attorneys to earn economic rents on lawsuits, even though attorneys remain free to compete with respect to the contingent fee.

Our argument relies on the moral hazard problem inherent in the attorney-client relationship. When attorney effort is not verifiable, contingent fees serve a dual role: in addition to compensating the attorney, contingent fees also provide the incentive for the attorney to put forth effort. Since attorneys put forth less effort at lower contingent fees, clients may prefer a higher contingent fee to the one that yields zero profits. Therefore, when the fixed fee is restricted, an otherwise competitive market need not offer the contingent fee that yields zero profits. Instead, the contingent fee exhibits downward rigidity at the value that maximizes the client's surplus, even if attorneys would accept a lower fee. Clients are unwilling to hire an attorney who offers a lower contingent fee, because doing so would reduce their net recovery—the lower level of attorney effort induced by the lower contingent fee would reduce the recovery by enough to outweigh the client's larger share of the recovery. As a result, attorneys cannot undercut this equilibrium by offering a lower contingent fee.

The positive rents created by these restrictions may not constitute pure profits, once the costs of entry into the legal profession are taken into account. To address this point, we allow for the possibility that entry is costly but otherwise unrestricted. Attorneys then enter until the rents exactly offset the

¹ Marc J. Shukaitis, A Market in Personal Injury Tort Claims, 16 J. Legal Stud. 329, 331 (1987).

² Max Radin, Maintenance by Champerty, 24 Cal. L. Rev. 48, 66 (1935); Charles W. Wolfram, Modern Legal Ethics 507 (1986); and Samuel R. Gross, We Could Pass a Law . . . What Might Happen If Contingent Legal Fees Were Banned, 47 DePaul L. Rev. 321, 325–28 (1998). For further discussion, see Section IIB *infra*.

³ For further discussion, see Section IIB *infra*.

costs of entry, yielding zero economic profits. Nevertheless, eliminating the restrictions after the entry costs are sunk would impose ex post losses on incumbent attorneys, who could no longer recover their costs through rents. Maintenance of the restrictions is therefore in the incumbents' interest, even if attorneys do not earn positive economic profits.

Our story is similar to the efficiency wage theory, which postulates that employers may find it optimal to pay wages in excess of employees' reservation wages when monitoring is either costly or imperfect.⁴ However, according to that theory, agents who are not monitored always put forth the minimum level of effort. In our model, the agent chooses a positive level of effort even though there is no monitoring because the contingent fee makes the attorney's reward dependent on the outcome. Similarly, agents in the efficiency-wage model would choose positive effort, regardless of the level of monitoring, if their compensation were contingent on the outcome.

On a formal level, our paper is most closely related to those papers that view contingent fees as a means of alleviating moral hazard. Bruce Hay characterizes optimal contingent fees when the fixed fee is constrained to equal zero.⁵ In a later work, Hay uses a model that allows for out-of-court settlements in addition to moral hazard to show that the client can generally benefit by paying a relatively large contingent fee if the lawsuit goes to court and a relatively small fee if it is settled out of court.⁶ M. L. Schwartz and D. J. B. Mitchell focus on whether contingent fees encourage excess litigation and the related question of whether fee caps would lead to less litigation.⁷ James Dana and Kathryn Spier analyze the case in which the attorney is better informed about the merits of the lawsuit than the client, so that there is moral hazard with regard to legal advice.⁸ Patricia Danzon considers the case in which effort is effectively observable.⁹

II. ETHICAL CONSTRAINTS ON FIXED FEES

A. *Development of Rules*

The ethical restrictions imposed on attorneys are related to the general prohibitions on the purchase and sale of personal injury claims and to the

⁴ See, for example, Carl Shapiro & Joseph E. Stiglitz, *Equilibrium Unemployment as a Worker Discipline Device*, 74 *Am. Econ. Rev.* 433 (1984).

⁵ Bruce L. Hay, *Contingent Fees and Agency Costs*, 25 *J. Legal Stud.* 503 (1996).

⁶ Bruce L. Hay, *Optimal Contingent Fees in a World of Settlement*, 26 *J. Legal Stud.* 259 (1997).

⁷ M. L. Schwartz & D. J. B. Mitchell, *An Economic Analysis of the Contingency Fee and Personal Injury Litigation*, 22 *Stan. L. Rev.* 1125 (1970).

⁸ James D. Dana, Jr., & Kathryn E. Spier, *Expertise and Contingent Fees: The Role of Asymmetric Information in Attorney Compensation*, 9 *J. L. Econ. & Org.* 349 (1993).

⁹ Patricia Munch Danzon, *Contingent Fees for Personal Injury Litigation*, 14 *Bell J. Econ.* 213 (1983).

English common law's prohibition against champerty.¹⁰ Champerty is defined as the financing of a lawsuit by someone other than the plaintiff who is to be paid from the proceeds of the lawsuit. The rule against champerty can be traced back to the Greeks and Romans.¹¹ However, the prohibition has been abandoned or deemphasized in many of the American states during the last century.¹² In some cases, nonattorney investors now purchase personal injury claims from plaintiffs.¹³

Nevertheless, each state continues to impose ethical restrictions on attorney payments to clients, generally based on standards set by the ABA.¹⁴ The ABA Canons of Professional Ethics, adopted in 1908, stated that "the lawyer should not purchase any interest in the subject matter of the litigation which he is conducting."¹⁵ The Canons further underscored this prohibition on financial assistance to clients by stating that "a lawyer may not . . . pay or bear the expenses of litigation; he may in good faith advance expenses as a matter of convenience, but subject to reimbursement."¹⁶ Since this rule required client reimbursement of litigation expenses even if the lawsuit was lost, the minimum fixed fee (payment by an unsuccessful client) was not only nonnegative, but positive and equal to litigation expenses. Also, since the only permissible loan mentioned was the advancement of litigation expenses, most states held that lawyers could not make other loans to clients, even if losing clients were required to repay them.¹⁷

When the ABA replaced the Canons with the Model Code of Professional Responsibility in 1970, the restrictions were little changed. The Model Code prohibited a lawyer from acquiring a proprietary interest in the subject matter of litigation but added that a reasonable contingent fee was permitted.¹⁸ It also stated that "a lawyer shall not advance or guarantee financial assistance to a client, except that a lawyer may advance or guarantee the expenses of litigation, including court costs, expenses of investigation, expenses of medical examination, and costs of obtaining and presenting evidence, provided the client remains ultimately liable for such expenses."¹⁹

¹⁰ See Shukaitis, *supra* note 1, at 330.

¹¹ See Radin, *supra* note 2, at 48–57.

¹² See *id.* at 68; and Peter Karsten, Enabling the Poor to Have Their Day in Court: The Sanctioning of Contingency Fee Contracts, A History to 1940, 47 DePaul L. Rev. 231, 235–42 (1998).

¹³ See Richard B. Schmitt, Staking Claims: A Las Vegas Lender Tests Odds in Court—and Forms an Industry, Wall St. J., September 15, 2000, at A1, col. 6.

¹⁴ The history of the ABA rules is described by American Bar Association, ABA Compendium of Professional Rules and Standards 7–11 (1997), and Stephen Gillers & Roy D. Simon, Jr., Regulation of Lawyers: Statutes and Standards, at xvii (1996).

¹⁵ Canon of Professional Ethics 10 (1956).

¹⁶ *Id.* at 42.

¹⁷ See Wolfram, *supra* note 2, at 507–8 (citing cases and bar association opinions).

¹⁸ Model Code of Professional Responsibility Disciplinary Rule 5-103(A) (1983).

¹⁹ *Id.* at 5-103(B).

However, many attorneys who advanced litigation expenses did not actually collect these expenses from unsuccessful clients.²⁰ In practice, the minimum fixed fee under both the Canons and the Model Code was zero rather than positive.

The ABA replaced the Model Code with the Model Rules of Professional Conduct in 1983. Model Rule 1.8(j) continues the prohibition on a proprietary interest other than a reasonable contingent fee.²¹ In a change, however, Model Rule 1.8(e) states that “a lawyer shall not provide financial assistance to a client in connection with pending or contemplated litigation, except that a lawyer may advance court costs and expenses of litigation, the repayment of which may be contingent on the outcome of the matter.”²² This rule recognizes that losing clients are unlikely to pay litigation expenses and merely requires that the fixed fee paid by a losing client be equal to or greater than zero.

Some state rules deviate to some extent from the ABA Model Rules. The Appendix describes the ethical restrictions in the 50 states and the District of Columbia. Two jurisdictions allow negative fixed fees to some extent. The District of Columbia permits attorneys to provide “financial assistance which is reasonably necessary to allow the client to institute or maintain the litigation.”²³ Texas allows attorneys to loan “reasonably necessary medical and living expenses,” with repayment contingent on the outcome of the litigation.²⁴ Since the allowable payments are limited to the stated category of expenses, however, the minimum fixed fee is still zero for lawsuits in which these types of expenses are not incurred.

Four states explicitly allow an attorney to lend “emergency financial assistance” to a client.²⁵ In addition, California allows loans to clients for any purpose.²⁶ (As discussed in Section IIB below, these states impose some interesting restrictions on the manner in which attorneys can provide such loans.) In some other states, courts have permitted loans of living and medical expenses, although the Rules appear to prohibit them. Since losing clients remain ultimately liable for repayment of these loans, the minimum fixed

²⁰ See Dana & Spier, *supra* note 8, at 353 n.14; Robert H. Aronson & Donald T. Weckstein, Professional Responsibility in a Nutshell 276 (1991); Kevin M. Clermont & John D. Currivan, Improving the Contingent Fee, 63 Cornell L. Rev. 529, 532 n.3 (1978); and Shukaitis, *supra* note 1, at 339 n.52.

²¹ Model Rule of Professional Conduct 1.8(j) (2000).

²² *Id.* at 1.8(e).

²³ District of Columbia Rule of Professional Conduct 1.8(d)(2) (2000).

²⁴ Texas Disciplinary Rule of Professional Conduct 1.08(d)(1) (2001).

²⁵ Alabama Rule of Professional Conduct 1.8(e)(3) (2000); Minnesota Rule of Professional Conduct 1.8(e)(3) (1999); Montana Rule of Professional Conduct 1.8(e)(3) (1999); and North Dakota Rule of Professional Conduct 1.8(e)(3) (2000).

²⁶ Rule of Professional Conduct of the State Bar of California 4-210(A)(2) (2000).

fee is still formally zero. However, the actual fixed fee is negative if losing clients do not repay these loans.

The Appendix lists 13 states that depart from the Model Rules in the opposite direction. Seven states continue to formally require that losing clients repay litigation expenses (as the Canons and Model Code had required) unless they are indigent or unable to repay, and six other states formally require such repayment by all losing clients, even those who are indigent. However, these restrictions remain largely unenforced.

B. Anticompetitive Purpose

A variety of arguments have been advanced to explain the ethical restrictions. Radin notes that the rise of the ban in ancient Greece and Rome reflected the belief that litigants should prepare and deliver their own arguments and should be accompanied to the trial by only their relatives and friends. The legal system did not accept financial arrangements that led to “interference” by outsiders with no personal interest in the litigation. Radin notes that this rationale became less relevant after the professional attorney came into existence.²⁷

Shukaitis identifies four arguments commonly made against a market in personal injury tort claims: spurious claims would become more frequent, the volume of litigation would increase, the right to recover from personal injury is inherently inalienable, and claims buyers would take advantage of uninformed tort victims. However, he states that “today one must question whether any reason remains for prohibiting assignments to avoid maintenance” and ultimately concludes “that a market in personal injury tort claims would provide substantial benefits that would more than outweigh the costs.”²⁸

Heuristic evidence suggests that the restrictions have survived, at least in part, because they restrict competition. Max Radin noted that, at the time of his writing, the ban on champerty tended to prevent agreements between plaintiffs and less established attorneys and stated that “in most instances, the modern objections to champerty are voiced by the more successful members of the profession and on behalf of propertied defendants.”²⁹ Peter Karsten similarly notes that defendants (railroads and physicians) and their attorneys opposed the relaxation of the champerty prohibition in the late nineteenth century.³⁰ A leading legal treatise comments that contemporary rules against attorney financial assistance to clients “are also transparently concerned with the risk that the promise of money advances would be employed by some

²⁷ Radin, *supra* note 2, at 65–69.

²⁸ Shukaitis, *supra* note 1, at 330.

²⁹ Radin, *supra* note 2, at 66.

³⁰ Karsten, *supra* note 12, at 254.

lawyers to solicit clients.”³¹ Samuel Gross concludes that a market in tort claims would be likely to benefit plaintiffs but that potential losses to plaintiffs’ attorneys and to defendants probably explain opposition to such a market.³²

Courts and bar associations have sometimes stated candidly that the ethical restrictions are intended to suppress price competition among attorneys. The Maryland Court of Appeals justified the restrictions by stating, “An important public policy interest is to avoid unfair competition among lawyers on the basis of their expenditures to clients. Clients should not be influenced to seek representation based on the ease with which monies can be obtained.”³³ The Arizona Supreme Court commented that “the practice of making advances to clients, if publicized, would constitute an improper inducement for clients to employ an attorney. . . . [B]etween a lawyer who offers such an agreement and a lawyer who does not, the client will choose the lawyer who offers the lesser financial obligation.”³⁴ The Kentucky Bar Association recently reaffirmed the state’s ban on advances for living and medical expenses after noting that “dropping the time-honored rule will invite bidding by lawyers for clients.”³⁵ When the District of Columbia Court of Appeals modified its rules in 1990 to allow attorneys to provide financial assistance that a client needs to maintain the litigation (a rule more permissive than any other jurisdiction except Texas), it still cautioned that the “provision does not permit lawyers to ‘bid’ for clients by offering financial payments beyond those minimum payments necessary to sustain the client.”³⁶

In a particularly revealing development, several states have tolerated some financial assistance to clients (particularly loans) under conditions that ensure that they will not place competitive pressures on other attorneys. The five states that allow attorneys to loan emergency financial assistance to clients require that “no promise or assurance of financial assistance [be] made to the client . . . prior to the employment of the lawyer”³⁷ or that loans be made only “after employment.”³⁸

The Louisiana Supreme Court allowed attorneys to loan reasonably necessary living expenses to clients only if “the advances were not promised as

³¹ Wolfram, *supra* note 2, at 507.

³² Gross, *supra* note 2, at 325–28.

³³ Attorney Grievance Committee v. Kandel, 563 A.2d 387, 390 (Md. 1989).

³⁴ *In re Carroll*, 602 P.2d 461, 467 (Ariz. 1979).

³⁵ Kentucky Bar Association Op. E-375 (1995).

³⁶ District of Columbia Rule of Professional Conduct 1.8 cmt. (1990).

³⁷ Alabama Rule of Professional Conduct 1.8(e)(3) (2000); Minnesota Rule of Professional Conduct 1.8(e)(3) (1999); Montana Rule of Professional Conduct 1.8(e)(3) (1999); and North Dakota Rule of Professional Conduct 1.8(e)(3) (2000).

³⁸ Rule of Professional Conduct of the State Bar of California 4-210(A)(2) (2000). Also see Wolfram, *supra* note 2, at 509 n.89 (stating that California courts have interpreted the rule as forbidding attorneys to discuss the availability of loans before representation begins).

an inducement to obtain professional employment, nor made until after the employment relationship was commenced . . . and the attorney did not encourage public knowledge of this practice as an inducement to secure representation of others.”³⁹ The Missouri Supreme Court, in allowing an attorney to make a small loan to a destitute client, warned, “[O]f course, the loan should not be the consideration for the employment.”^{40,41}

The above-mentioned rules are not the only fee restrictions that the legal profession has imposed. Each state’s bar association adopted schedules of minimum fixed fees for a wide variety of legal services until 1975, when such schedules were struck down by the U.S. Supreme Court as a form of price-fixing.⁴² These schedules had an explicitly anticompetitive rationale.⁴³ However, the rules prohibiting the purchase of legal claims have apparently escaped antitrust challenges, even though they also prescribe a minimum fee.

We now examine the impact of such restrictions on the welfare of attorneys and clients.

III. THE BASIC MODEL

A risk-neutral client requires an attorney’s services to recover damages. All attorneys are risk neutral, and the market for legal services is competitive, with the exception of the moral hazard problem discussed below.

Following previous authors,⁴⁴ we allow for the possibility that lawsuits require fixed costs, such as legal filing fees and initial investigation. We assume that fixed costs have a nonnegative dollar value M . Letting E denote the dollar value of the attorney’s effort (in addition to the fixed costs), total litigation costs equal $M + E$.

Let $A(E)$ denote the expected award (gross of legal fees), as a function of effort. We make the standard assumptions that the function is increasing and strictly concave, $A'(\cdot) > 0$, $A''(\cdot) < 0$. For convenience, we also assume that a positive award can be obtained only with positive attorney effort,

³⁹ Louisiana State Bar Association v. Edwins, 329 So.2d 437, 446 (La. 1976).

⁴⁰ In re Sizer, 267 S.W. 922, 924 (Mo. 1924).

⁴¹ Also see In re Berlant, 328 A.2d 471, 479 (Pa. 1974) (Manderino, J., concurring and dissenting) (disciplinary action against an attorney who advanced living expenses was appropriate only because the advance was designed to influence the client to retain the attorney).

⁴² Goldfarb v. Virginia State Bar, 421 U.S. 773 (1975) (invalidating Fairfax County Bar Association minimum-fee schedule under the Sherman Act, 15 U.S.C. § 1) (unanimous decision).

⁴³ The bar association permitted an attorney to charge a lower fee to a deserving client but threatened disciplinary action against any attorney who, “purely for his own advancement, intentionally and regularly bills less . . . to increase his business with resulting personal gain . . . [and] to encroach upon the employment of another.” Quoted in *Goldfarb*, *supra* note 42, at 777 n.4.

⁴⁴ See, for example, Schwartz & Mitchell, *supra* note 7, at 1128; and P. J. Halpern & S. M. Turnbull, Legal Fees Contracts and Alternative Cost Rules: An Economic Analysis, 3 Int’l Rev. L. & Econ. 3, 13 (1983).

$A(0) = 0$. In view of the risk-neutrality assumption, we refer to A as the “award” rather than the “expected award” without loss of generality.

We assume that the client and the attorney both know the $A(E)$ function but that the client cannot observe the attorney’s effort E . Let F denote the fixed fee (the fee paid to the attorney by a client for whom no damages are awarded) and f denote the contingent fee (the fraction of the award received by the attorney). For each individual lawsuit, the attorney receives $fA(E) + F$. The fee is a linear function of the award.⁴⁵

The attorney’s profits are $\pi \equiv fA(E) + F - E - M$. The client’s surplus (award net of legal fees) is $S \equiv (1 - f)A(E) - F$. The combined value of the lawsuit to the attorney and client is the award minus the effort and fixed costs, $V \equiv S + \pi = A(E) - E - M$.

We begin by finding the effort level that maximizes the combined value of the lawsuit. (Of course, this is generally not the social optimum, since the lawsuit also affects the defendant and the court system and has incentive effects on other potential plaintiffs and defendants.) The maximum combined value is $V^0 \equiv \max_{E>0} A(E) - E - M$. We confine our attention to lawsuits for which $V^0 > 0$, since other lawsuits will not be filed regardless of whether the fee structure is restricted.

The effort level that maximizes $A(E) - E - M$, denoted E^0 , is implicitly defined as the solution to the first-order condition

$$A'(E^0) = 1. \quad (1)$$

Note that this effort level does not depend on the fixed costs.

With unobservable attorney effort, this is a classic moral hazard problem. For any given fee structure, an attorney (conditional on taking the lawsuit) chooses effort E^* to maximize $\pi \equiv fA(E) + F - E - M$, which yields the first-order condition

$$fA'(E^*) = 1. \quad (2)$$

The combined value of the lawsuit is then $V(f) \equiv A(E^*(f)) - E^*(f) - M$. Note that the attorney’s effort and the combined value do not depend on F . So long as the lawsuit is filed, the fixed fee affects only the division of the combined value between the client and attorney.

For simplicity, we assume $\lim_{E \rightarrow 0^+} A'(E) = \infty$, which implies that the attorney’s effort (conditional on taking the lawsuit) is strictly positive for all contingent fees, $E^*(f) > 0$ for all $f > 0$. Differentiating (2) reveals that attorney effort is an increasing function of the contingent fee,

⁴⁵ We show in the next section that this linear structure is efficient in the unconstrained case. However, the linearity assumption is restrictive in the constrained case, a point to which we return in Section VI *infra*.

$$\frac{dE^*}{df} = \frac{-A'(E^*)}{fA''(E^*)} = \frac{-1}{f^2A''} > 0. \quad (3)$$

Attorney effort is more sensitive to the contingent fee if the award function is flatter (A'' has small absolute value). When the award function is relatively flat, large changes in effort are required to achieve any given change in the marginal product of effort (or to respond to any given change in the contingent fee). Moral hazard is then more severe.

The combined value is an increasing function of the contingent fee at all $f < 1$:

$$\frac{dV}{df} = (A' - 1) \frac{dE^*}{df} = \frac{f - 1}{f^3A''}. \quad (4)$$

The sign of dV/df is positive for $f < 1$. Therefore, as long as the attorney's participation constraint is met, the combined value is maximized at $f = 1$, when the attorney first-order condition (2) is identical to (1).

If fees are unconstrained, competition achieves this outcome. The equilibrium fee structure maximizes the client's surplus, subject to the restriction that attorney profits are nonnegative. Since effort is not observable, the fee structure recognizes that the attorney responds with effort level $E^*(f)$. Therefore, the competitive equilibrium solves

$$\max_{f, F} S \equiv (1 - f)A(E^*) - F$$

$$\text{subject to } \pi \equiv fA(E^*) + F - E^* - M \geq 0,$$

where the argument of $E^*(f)$ has been suppressed.

The solution to this problem includes a 100 percent contingent fee, which maximizes the combined value of the lawsuit by inducing the efficient level of effort. The fixed fee, which does not affect attorney effort, is set at the lowest (most negative) value that keeps profits nonnegative, so the client receives a fixed payment of V^0 from the attorney and extracts the entire combined value.

PROPOSITION 1. When the fee structure is not restricted, the equilibrium fee structure induces the efficient effort level and attorneys earn zero economic profits. The client "sells" the lawsuit to the attorney for a price equal to its maximum combined value.⁴⁶

The moral hazard problem is alleviated in the unconstrained equilibrium. However, this outcome is precluded by the fixed-fee restrictions discussed above.

⁴⁶ We do not prove this result because it is relatively intuitive and has been observed by previous authors. See, for example, Steven Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 55 *Bell J. Econ.* 55, 56 (1979); and Hay, *supra* note 5, at 504.

IV. ECONOMIC EFFECTS OF MINIMUM-FIXED-FEE RESTRICTIONS

We now consider the effects of a general constraint on minimum fixed fees, $F \geq K$, where the Model Rules require a minimum fixed fee of zero. We confine our attention to the case when $K > -V^0$, which implies that the constraint is binding. As before, the equilibrium fee structure maximizes the client's surplus, subject to the attorney participation constraint and now the minimum-fixed-fee constraint,

$$\max_f S \equiv (1 - f)A(E^*) - K$$

$$\text{subject to } \pi \equiv fA(E^*) + K - E^* - M \geq 0.$$

The equilibrium contingent fee depends on how changes in the contingent fee (holding the fixed fee constant at K) affect the client surplus and the attorney participation constraint.

Let $f_z(K)$ denote the contingent fee that yields zero attorney profits when the fixed fee is constrained to equal K . This zero-profit fee is implicitly defined by

$$M - f_z A(E^*(f_z)) + E^*(f_z) = K. \quad (5)$$

Implicit differentiation of (5) yields $\partial f_z / \partial K = -1/A < 0$, which reveals that the zero-profit fee is a decreasing function of K . In other words, if the minimum fixed fee is higher (possibly less negative), the attorney can break even with a smaller share of the award. One might expect that, for any given K , competition drives the contingent fee down to this zero-profit fee. We now demonstrate that this need not occur and that attorneys can earn positive profits.

A higher contingent fee reduces the client's share of the award, but it also increases the award by inducing greater attorney effort. Therefore, the client's preferred contingent fee is not always the lowest contingent fee that the attorney is willing to accept. Assuming that the attorney takes the lawsuit, the client's surplus $S(f) = (1 - f)A(E(f)) - K$ is maximized by a contingent fee, denoted by \hat{f} , that satisfies the following first-order condition,

$$(1 - \hat{f})A'(E^*(\hat{f})) \frac{dE^*}{df} = A(E^*(\hat{f})). \quad (6)$$

For a small increase in the contingent fee, the left-hand side of (6) is the increase in the client's surplus that results from the additional attorney effort, while the right-hand side is the loss in the client's share of the award. It is

easy to show that this surplus-maximizing fee is strictly positive and independent of K .⁴⁷

Equation (6) may have multiple solutions if the surplus function $S(f)$ has multiple peaks. For simplicity, we assume that the function is single peaked⁴⁸ to ensure a unique solution (although our main result that the ethical constraint can allow economic rents holds without this assumption).

Rewriting equation (6) yields an expression for the ratio of the attorney's and client's marginal payoffs at the surplus-maximizing fee,

$$\frac{\hat{f}}{1 - \hat{f}} = \frac{(dA/df)\hat{f}}{\hat{A}}, \quad (7)$$

where $dA/df = A'(dE^*/df)$. This ratio equals the (local) elasticity of the award with respect to the contingent fee.⁴⁹ When the award payoff is less elastic, a lower value of the contingent fee maximizes $(1 - f)A$.

Under the minimum-fixed-fee restriction, the client prefers the surplus-maximizing fee \hat{f} to any other contingent fee, as long as the attorney accepts the case. It is easy to show that, at any given value of K , attorney profits are an increasing function of the contingent fee. Hence, under the ethical restriction, the attorney prefers the surplus-maximizing fee to any lower contingent fee. Therefore, a contingent fee lower than \hat{f} cannot be an equilibrium outcome since both parties prefer a higher fee. On the other hand, a contingent fee less than f_z cannot be an equilibrium since attorneys would earn negative profits. This analysis directly implies the following proposition:

PROPOSITION 2. If the lawsuit is filed, the equilibrium contingent fee is the greater of the zero-profit fee and the surplus-maximizing fee. The attorney earns strictly positive profits only if the surplus-maximizing fee is greater than the zero-profit fee.

We now derive necessary and sufficient conditions for attorneys to earn positive profits, which occurs when the surplus-maximizing fee is greater than the zero-profit fee and the client files suit. Define $\hat{E} = E(\hat{f})$ and $\hat{A} = A(\hat{E})$. When K equals $\hat{E} + M - \hat{f}\hat{A}$, equation (5) implies that $f_z(K) = \hat{f}$. Since the zero-profit contingent fee decreases as K increases, it follows that $f_z(K) < \hat{f}$ if and only if $K > \hat{E} + M - \hat{f}\hat{A}$. On the other hand, the client files suit only if $K \leq (1 - \hat{f})\hat{A}$, since the client's surplus would otherwise be neg-

⁴⁷ At $f = 1$, the client receives $-K$. At $f = 0$, the client receives $-K$ since $E^*(0) = 0$ and $A(0) = 0$. However, by choosing some $f \in (0, 1)$, the attorney will put forth a positive amount of effort and the client will receive a strictly positive share of the recovery less K . Therefore, $\hat{f} \in (0, 1)$.

⁴⁸ Given that $S(0) = S(1) = 0$, the surplus function has a single peak if it is quasi-concave.

⁴⁹ By making substitutions from equations (2) and (3), it is possible to derive other algebraically equivalent expressions for f , as in Hay, *supra* note 5, at 511. None of the expressions are in closed form; they all relate the contingent fee to endogenous quantities that depend on the fee.

ative. Algebra confirms that a range for K that satisfies both inequalities exists if and only if $\hat{V} = \hat{A} - \hat{E} - M$ is positive, which is the case we focus on below.⁵⁰

The condition that \hat{V} must be positive has an intuitive interpretation. At any contingent fee, the combined value of the lawsuit equals the sum of attorney profit and client surplus. If the combined value is not positive at the surplus-maximizing fee, then the attorney cannot earn positive profits without the client receiving negative surplus. Of course, negative surplus is inconsistent with client participation. Hence, it is possible for the attorney to earn positive profits while still leaving nonnegative surplus for the client only if the combined value is positive at the surplus-maximizing fee.

On the other hand, the requirement that \hat{V} is positive is not sufficient to guarantee that the attorney earns positive profits, as the minimum fixed fee must also be in the appropriate range. Recall that the fixed fee affects neither attorney effort nor the combined value but only the division between attorney profits and client surplus. It follows that as long as \hat{V} is positive, a range of fixed fees exist that allocates the total value in a manner such that both profits and client surplus are positive. The relevant range for the minimum fixed fee is given by the two inequalities above that guarantee positive profits and nonnegative surplus.

In this range, the minimum fixed fee is sufficiently high that the associated zero-profit contingent fee is lower than the surplus-maximizing fee. As stated in Proposition 2, competition does not drive the equilibrium contingent fee below the surplus-maximizing fee since a lower contingent fee would decrease client surplus. Also, in this range, the fixed fee is not so high that client surplus is nonnegative. So the client files the lawsuit and the attorney earns positive profits. To summarize:

PROPOSITION 3. If the combined value of the lawsuit is positive at the surplus-maximizing fee, then for any minimum fixed fee greater than $\hat{E} + M - \hat{f}\hat{A}$ and less than or equal to $(1 - \hat{f})\hat{A}$,

- i) the lawsuit is filed,
- ii) the equilibrium contingent fee is the surplus-maximizing fee,
- iii) client surplus is nonnegative,
- iv) attorney profits are strictly positive, and
- v) the combined value of the lawsuit is independent of the minimum fixed fee.

Note that attorney profits, which are given by $\pi = \hat{f}\hat{A} + K - \hat{E} - M$, decrease as the minimum fixed fee is decreased within the stated interval. Attorneys are harmed by even a marginal relaxation of the restriction, because a \$1 decrease in K implies a \$1 shift of surplus from the attorney to the client.

⁵⁰ When \hat{V} is negative, attorneys earn zero profits on all lawsuits that go to court, although some lawsuits may be dropped if K is positive and sufficiently large.

Client surplus, which is given by $(1 - \hat{f})\hat{A} - K$, increases as the fixed fee restriction is relaxed.

On the other hand, if the minimum fixed fee K is below the range set forth in Proposition 3, the associated zero-profit fee is greater than the surplus-maximizing fee. Competition then forces the contingent fee down to the zero-profit level. With no profits, the client surplus equals the value of the lawsuit, which is strictly positive. For minimum fixed fees in this lower range, small decreases in K do not affect attorney profits since the equilibrium contingent fee rises to ensure attorney participation. However, client surplus is larger at lower fixed fees, because the higher associated contingent fee induces the attorney to choose a higher effort level. With more effort, the value of the lawsuit increases, and this increase in value accrues to the client.⁵¹ In this range, therefore, relaxing the minimum fixed fee is a weak Pareto improvement, strictly increasing the client surplus while keeping attorney profits constant at zero. The next proposition summarizes this discussion.

PROPOSITION 4. If the combined value of the lawsuit is positive at the surplus-maximizing contingent fee, then for any minimum fixed fee less than or equal to $\hat{E} + M - \hat{f}\hat{A}$ but greater than $-V^0$,

- i) the lawsuit is filed,
- ii) the equilibrium contingent fee is the zero-profit contingent fee,
- iii) client surplus equals the combined value of the lawsuit, and
- iv) the combined value of the lawsuit is a decreasing function of the minimum fixed fee.

We now show that the minimum fixed fee specified by the Model Rules (K equal to zero) implies positive attorney profits when the fixed costs of litigation are sufficiently small. To see this, suppose that fixed costs are zero. Then the assumption that the marginal product of attorney effort is initially very large implies that the attorney can earn strictly positive profits by choosing a positive (though possibly very small) level of effort. Since fixed costs do not affect the attorney's effort (equation (2)), introducing fixed costs of M simply reduces profits by M dollars. So profits remain positive if M is sufficiently small.

More formally, the positive-profits interval exists ($\hat{V} > 0$) if $M < \hat{A} - \hat{E}$,

⁵¹ Formally, let $S_z(K)$ and $V_z(K)$ denote the client's surplus and the combined value of the lawsuit when the fixed fee is equal to K and the contingent fee equals the corresponding zero-profit level, $f_z(K)$. By construction, we have $S_z(K) = V_z(K) = (1 - f_z(K))A(E(f_z(K))) - K$, so straightforward differentiation yields

$$\frac{dV(K)}{dK} = \frac{dS_z(K)}{dK} = \frac{1 - f_z}{f_z^3 A A''} < 0.$$

and algebra confirms that $K = 0$ lies within the interval when $M < \hat{f}\hat{A} - \hat{E}$.⁵² The latter inequality clearly implies the former. It follows that if the fixed costs are not too large, they satisfy the latter inequality, and a zero fixed fee lies in the positive-profits interval described by Proposition 3.

PROPOSITION 5. If fixed costs are sufficiently small, then a minimum fixed fee equal to zero yields positive profits.

The top panel of Figure 1 graphs the equilibrium contingent fee as a function of the minimum fixed fee (holding constant the award function and the fixed costs). During the zero-profit interval, the contingent fee declines from unity, the unconstrained optimum, to the surplus-maximizing fee, \hat{f} . The exact value of the contingent fee in the zero-profit region is implicitly defined by equation (5). The contingent fee then remains equal to \hat{f} throughout the positive-profits interval.

The bottom panel shows the behavior of client surplus and attorney profits as the minimum fixed fee is increased. The client's surplus declines from V^0 to \hat{V} during the zero-profit interval (as does the combined value, which equals client surplus in the zero-profit interval). Attorneys continue to earn zero profit, as competition drives down the contingent fee (below its unconstrained value of unity) to the zero-profit value associated with the minimum fixed fee. The reduction in the contingent fee lowers attorney effort, the resulting award, and the client surplus.

The combined value remains constant at \hat{V} throughout the positive-profits interval. Throughout the positive-profits interval, increases in the minimum fixed fee do nothing more than shift surplus from the client to the attorney. Thus, attorneys are harmed by even a marginal relaxation of the restriction, because \$1 decrease in K shifts \$1 from the attorney to the client. At the other extreme, if K is positive and sufficiently great, the lawsuit is abandoned, because no contingent fee makes the lawsuit attractive to the client.

This analysis demonstrates that the zero-fixed-fee restriction can generate positive attorney profits. The availability of these profits gives each attorney an incentive to take additional lawsuits and creates incentives for individuals to enter the legal profession. Can the positive profits persist in the face of these incentives, and, if not, do lawyers have any motivation to impose the restriction? We now address these issues in a more dynamic model and demonstrate that attorneys continue to have an incentive to maintain the ethical restriction.

V. SUNK ENTRY COSTS AND NONPRICE COMPETITION

In this section, we allow entry into the market for legal services under the assumption that entry requires a sunk investment (reflecting the substantial

⁵² It is easy to see that $\hat{f}\hat{A} - \hat{E} > 0$. Since $A(E)$ is an increasing concave function and $A(0) = 0$, it follows that $A(E) > EA'(E) = E/f$, where the last equality makes use of equation (2).

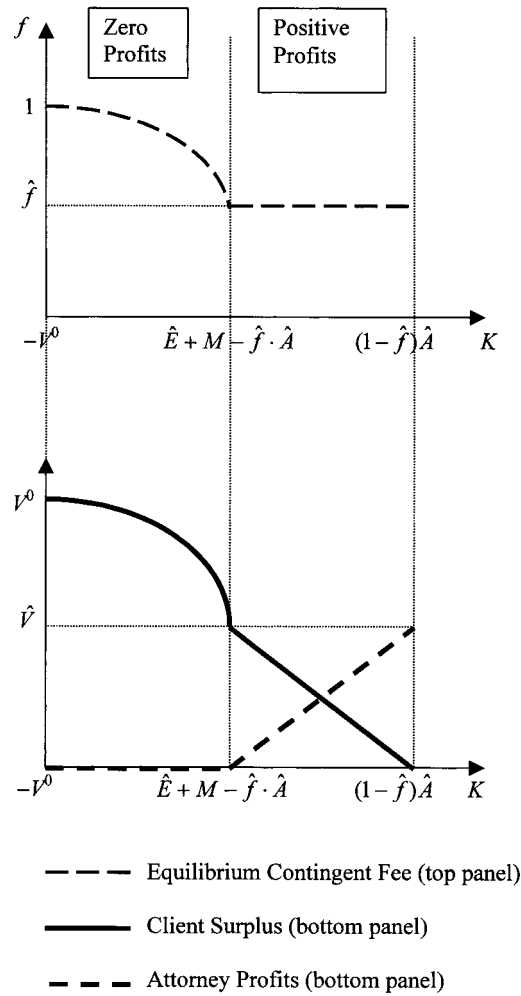


FIGURE 1.—Legal fee restrictions, moral hazard, and attorney rents

costs of legal education). With unrestricted entry, economic rents earned by existing attorneys from their lawsuits should, in equilibrium, equal a normal return on their sunk entry investment. After accounting for those investment costs, attorneys earn no pure profits. Nevertheless, we show that attorneys who have already entered have an incentive to maintain the fee restrictions because they cannot recover their entry costs without them.

Consider a simple variant of the above model. Let L denote the number of lawyers and T denote the sunk cost of entry. Attorneys are identical, and

each receives a random allocation of the total N lawsuits available to the profession. We use $\bar{\pi}(K)$ to denote the average profit earned on a lawsuit. Proposition 3 implies that $\bar{\pi}(K)$ is an increasing function of K . With unrestricted entry, attorneys enter and the number of lawsuits per attorney (N/L) falls until the rents earned on lawsuits equals the entry costs, driving ex ante profits to zero:

$$\Pi = \left(\frac{N}{L}\right) \bar{\pi}(K) - T = 0. \quad (8)$$

Although attorneys are not earning economic profits once one accounts for entry costs, they have an economic interest to maintain the constraints. If the fee restrictions are unexpectedly removed immediately after entry occurs, $\bar{\pi}(K)$ falls to zero, and incumbent attorneys incur ex post losses equal to T . Even a marginal relaxation of the constraint reduces $\bar{\pi}(K)$ and induces ex post losses. Of course, the relaxation of the restrictions does not harm subsequent cohorts of entrants, because they are aware of the change when they make their entry decisions.

Starting from a point at which fees are unrestricted, it still may not be clear that attorneys ever have an incentive to introduce the restrictions. If entry occurs with a lag, however, such an incentive exists because the cohort that imposes the restrictions earns temporary pure profits and enjoys higher lifetime incomes. The discussion in Section IIB also suggests an alternative explanation. The champerty prohibition appears to have been initially imposed for unrelated reasons during an era in which litigants did not hire professional attorneys. The above analysis may explain why these historical remnants have been maintained.

Given attorneys' inability to attract clients by charging lower fees, they may attempt to attract them through advertising or other forms of nonprice competition. Of course, there is little reason to expend significant resources on attracting clients if lawsuits do not yield positive profits. Therefore, our model allows us to interpret previous general bans on attorney advertising as attempts to limit nonprice competition.⁵³

It is beyond the scope of this paper to model the precise mechanism through which nonprice competition may attract clients. We can, however, sketch its implications for our results using a variant of the present model. Rather than model the nonprice competition directly, we simply hypothesize that a relationship exists between an attorney's equilibrium expenditure on advertising (or other forms of nonprice competition) and the rents earned on a typical lawsuit, $\bar{\pi}(K)$. Specifically, we let $c(\bar{\pi}(K))$ be an attorney's equilibrium expenditure, where we assume that attorneys spend more money on advertising

⁵³ The advertising prohibitions were struck down by the U.S. Supreme Court as a violation of freedom of speech. *Bates v. State Bar of Arizona*, 433 U.S. 350 (1977) (invalidating the Arizona restriction under U.S. Const. Amends. I, XIV).

if lawsuits are, on average, more profitable. As long as potential entrants anticipate the nonprice competition, unrestricted entry then implies

$$\Pi = \left(\frac{N}{L}\right) \bar{\pi}(K) - c(\bar{\pi}(K)) - T = 0. \quad (9)$$

That is, attorneys enter the industry until the rents earned on lawsuits equal the sum of the entry costs and expenditures on nonprice competition, which drives ex ante profits to zero.

Now, once again, assume that the ethical restrictions are either eliminated or significantly relaxed after entry occurs. If K becomes sufficiently negative, virtually all lawsuits yield zero economic rents. (We know from Proposition 4 that it is not necessary for the ethical restriction to be eliminated in order for per-lawsuit profits to become zero.) Presumably, with zero economic rents, any significant nonprice competition would cease ($c(0) = 0$), which implies that attorneys earn ex post losses ($\Pi \equiv -T < 0$).

However, a negative minimum fixed fee need not drive rents on every lawsuit to zero in order for attorneys to be harmed. On the contrary, even if the rents on a typical lawsuit remain positive and nonprice competition ceases completely, attorneys may not be able to fully recover their sunk costs. We know that $\bar{\pi}(K)$ continues to fall as K becomes more negative. So ex post profits necessarily become negative despite the fact that expenditures on nonprice competition decrease and partially offset the loss in rents. For the sake of argument, suppose that nonprice competition essentially disappears as $\bar{\pi}(K)$ gets small. Then, for sufficiently small $\bar{\pi}(K)$, we have

$$\Pi = \left(\frac{N}{L}\right) \bar{\pi}(K) - T < 0. \quad (10)$$

Therefore, with or without nonprice competition, attorneys have good reason to maintain the minimum-fixed-fee restriction when the costs of entry cannot be recovered.

VI. EXTENSIONS

Throughout we have made several simplifying assumptions in order to maintain tractability. In this section, we explore the robustness of our results with respect to each of them.

A. *Client Moral Hazard and Asymmetric Information*

We have assumed the existence of a moral hazard problem from unobservable attorney effort, but not from unobservable client effort. As several authors have noted, the success of the lawsuit may require the active participation of both the client and the attorney, which creates a two-sided moral

hazard problem.⁵⁴ To be sure, when the award depends on the client's unobservable effort, the most efficient contingent fee is less than 100 percent in order to provide incentive for the client to put forth effort.

However, so long as client effort is of limited importance, the equilibrium contingent fee is likely to remain high, and the associated zero-profit fixed fee in the unconstrained equilibrium is still likely to be negative, although less negative than the value $-V^0$. On the other hand, if client moral hazard is sufficiently important relative to attorney moral hazard, it is theoretically possible that the unconstrained equilibrium entails a positive fixed fee. In this latter case, an ethical restriction requiring $F \geq 0$ is not binding and has no real effects.

Positive fixed fees are, however, rarely observed for personal injury lawsuits. The prevalence of zero fixed fees in the presence of a nonnegativity restriction compels the conclusion that the restriction is indeed binding in reality. Of course, as our analysis has shown, the mere fact that the constraint binds does not imply that rents are positive (see Proposition 4). Nevertheless, the logic underlying Proposition 5 continues to hold in the presence of client moral hazard, as long as the minimum-fixed-fee constraint is binding at zero. More precisely, at any positive contingent fee, the attorney chooses an effort level such that $fA(E) - E > 0$,⁵⁵ which implies positive profits for lawsuits with sufficiently small fixed costs. Therefore, our main result that the fee restrictions can allow economic rents for attorneys continues to hold in such environments.

We have also ignored client adverse selection, which has implications similar to those of client moral hazard. Daniel Rubinfeld and Suzanne Scotchmer establish that if the client has more information than the attorney about the quality of the lawsuit, the equilibrium contingent fee may be less than 100 percent.⁵⁶ If clients were allowed to sell lawsuits and attorneys unable to determine the true value of the suit, then clients would have an incentive to sell "bad" lawsuits to attorneys. For those lawsuits with true values that are difficult for the attorney to ascertain but are easily determined by the client, we would expect an unrestricted competitive market to require fixed fees that are strictly positive to screen the "bad" lawsuits. Nevertheless, as discussed above, we rarely observe positive fixed fees for personal injury lawsuits, which suggests that adverse selection is not a significant problem in practice.

In sum, the attorney's unobservable effort is likely to be far more important to the lawsuit's outcome than the client's unobservable effort. In many civil

⁵⁴ See Danzon, *supra* note 9, at 223; Shukaitis, *supra* note 1, at 340; and Daniel L. Rubinfeld & Suzanne Scotchmer, Contingent Fees for Attorneys: An Economic Analysis, 24 RAND J. Econ. 343, 349 n.14 (1993).

⁵⁵ See note 52 *supra*.

⁵⁶ Rubinfeld & Scotchmer, *supra* note 54, at 348–50.

suits, much of the client's participation can be ensured early in the litigation with written testimony, evidence of property damages, and medical reports. Providing this information also tends to dispel the client's informational advantage. It is not surprising, then, that client moral hazard and adverse selection appear to be of minor practical importance.

B. Risk Aversion

In this analysis, we have assumed that both clients and attorneys are risk neutral. As several authors note, it is plausible to assume that attorneys are risk neutral with respect to the outcome of each lawsuit, because they usually handle many (relatively) independent lawsuits.⁵⁷

Allowing risk-averse clients does not alter our basic results. The unconstrained equilibrium still involves a 100 percent contingent fee.⁵⁸ "Selling" the lawsuit to the attorney not only alleviates the moral hazard problem but also distributes the risk efficiently—to the risk-neutral attorney. Competition continues to drive expected attorney profits to zero.

Under the ethical constraint, holding the fixed fee constant, the qualitative result of Proposition 2 remains valid. The client's expected utility will be maximized at some interior value of the contingent fee, since at unity the attorney receives all of the proceeds, while at zero the attorney puts forth no effort and the client gets no recovery. A positive-profits equilibrium can still be sustained at this utility-maximizing fee.

C. Nonlinear Contracts

We have assumed throughout that the contract must be linear in the award. For the unconstrained case, this assumption was not restrictive, since a contingent fee of unity achieved the efficient outcome. However, the linearity assumption is restrictive in the constrained case, because it is likely that more general contracts, particularly those involving complex forms of nonlinearity, could improve client welfare.

On the whole, however, the linearity assumption is not contradicted by observation—most attorneys in civil suits are compensated by simple contingent fees. Furthermore, the nonlinearity that is observed tends to be of limited simple forms.⁵⁹

Despite the general complexity involved with nonlinear contracts, there is a simple situation in which restricting attention to linear fees entails no loss of generality. It arises when attorney effort affects only the probability of

⁵⁷ See Schwartz & Mitchell, *supra* note 7, at 1150–51; Clermont & Currivan, *supra* note 20, at 565 n.86; Shavell, *supra* note 46, at 66; and Rubinfeld & Scotchmer, *supra* note 54, at 346.

⁵⁸ See Shavell, *supra* note 46, at 56; and Halpern & Turnbull, *supra* note 44, at 16.

⁵⁹ See Hay, *supra* note 5, at 525; and Hay, *supra* note 6, at 272.

winning, not the expected value of the actual damage award, conditional on winning. This occurs when the damage award is determined by the “facts” of the lawsuit, such as medical bills or lost wages. The award function then has the form $A(E) = P(E)\tilde{\alpha}$, where $P(E)$ is the probability of winning as a function of effort and $\tilde{\alpha}$ is the expected value of the actual award, conditional on winning. In this case, any contract that is nonlinear in the actual award and that does not violate the ethical constraint is equivalent to a linear contract. In short, the linearity assumption may not be very restrictive if attorney effort primarily affects the probability of a civil suit’s success, with little impact on the size of the damage award.

D. Defense Attorneys

We have ignored the role of defense attorneys in this analysis. Since bar associations include defense attorneys as well as plaintiff’s attorneys, the impact of fee restrictions on their well-being is also relevant in a political economy explanation. While it is easy to see that fee restrictions benefit defendants by lowering awards, a full modeling of the effect on defense attorneys requires the resolution of several issues that we leave to further research. For example, the fact that defense attorneys usually are paid an hourly fee (rather than a contingent fee) suggests that defendants can better monitor attorneys. This is plausible since many defendants, such as insurance companies, either have their own in-house legal departments or deal with the same attorneys on a repeated basis. Given that the effort of plaintiffs’ attorneys may induce either more or less effort from defense attorneys, the reduction in the effort of the former because of the ethical restriction has ambiguous implications for the effort of the latter.

However, the most important point is that attorneys can, to a large extent, move between the two groups. Indeed, some attorneys divide their time between work for plaintiffs and for defendants. A simple no-arbitrage argument suggests that the payoffs to both types of work are likely to rise or fall together as the ethical restrictions are changed. A relaxation of the ethical restriction that reduces the profits of plaintiffs’ lawyers is likely to induce them to enter defense work, lowering the incomes of attorneys already practicing in that area. As a historical matter, defense attorneys, along with defendants, played a leading role in supporting a continued ban on champerty in the late nineteenth century.⁶⁰

VII. CONCLUDING REMARKS

We have provided a positive economic explanation for the seemingly inefficient ethical rules that prevent an attorney from “purchasing” a client’s legal claim to recover damages in a civil suit. If attorney effort is unob-

⁶⁰ See Karsten, *supra* note 12, at 254.

servable, these constraints create positive rents for attorneys whenever successful litigation does not involve large fixed costs. Intuitively, competition along the contingent-fee dimension does not force contingent fees down to a level that yields zero rents because such fees do not induce sufficient effort from attorneys. However, absent such ethical restrictions, competition removes the rents, and client welfare is improved.

Our analysis has also considered the implications of unrestricted entry when those entering the legal profession must make a nonrecoverable investment. While entry does not alter the equilibrium contingent fee, it does decrease the number of lawsuits per attorney. Entry continues until the total rent earned by a typical attorney just offsets the costs of entry, yielding zero ex post economic profits. However, elimination of the restrictions after entry has occurred removes the rents and causes ex post losses.

In sum, our analysis suggests that the prohibition of negative fixed fees can be understood as a means of maintaining rents for members of the legal profession. On a formal level, the ethical constraints are simple minimum fixed fees (equal to zero), yet they seem to have escaped antitrust challenges. While a positive minimum fixed fee would generally yield larger rents, it would be vulnerable to antitrust objections, in view of the Supreme Court's *Goldfarb* decision (discussed in Section II).

APPENDIX

ETHICAL RESTRICTIONS IN THE STATES AND WASHINGTON, D.C.

Category 1. $K < 0$ (under certain circumstances). Attorneys may make certain payments to clients (or certain loans without repayment by losing clients) (two jurisdictions: District of Columbia and Texas).⁶¹

Category 2. $K = 0$.

A. Litigation expenses can be loaned without repayment by losing clients; other loans can be provided (under certain restrictions) with repayment by losing clients⁶² (five jurisdictions: Alabama, California, Minnesota, Montana, and North Dakota).⁶³

B. Litigation expenses can be loaned without repayment by losing clients (31 jurisdictions: Alaska, Arkansas, Connecticut, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Mississippi, Missouri, Nevada, New Hampshire, New Jersey, Ohio, Oklahoma, Penn-

⁶¹ The two jurisdictions' rules identify slightly different types of financial assistance that can be provided. See text around notes 23–24 *supra* (describing these rules).

⁶² If attorneys do not actually collect loan repayments from losing clients, category 2A is economically equivalent to category 1.

⁶³ The California rule allows loans for any purpose, while the other four states' rules permit loans only for certain purposes. See text around notes 25–26 *supra* (describing types of loans permitted by rules). Also see text around notes 37–38 *supra* (describing how rules preclude the making of loans prior to the employment of the attorney).

sylvania, Rhode Island, South Carolina, Tennessee,⁶⁴ Utah, Vermont, West Virginia, Wisconsin, and Wyoming).

Category 3. $K = 0$ for some clients, $K > 0$ for others. Litigation expenses can be loaned without repayment by losing clients who are indigent or unable to pay, but other losing clients must repay⁶⁵ (seven jurisdictions: Arizona, Colorado, Michigan, New Mexico, Oregon, South Dakota, and Virginia).

Category 4. $K > 0$. Litigation expenses can be loaned, but losing clients must repay⁶⁶ (six jurisdictions: Iowa, Maine,⁶⁷ Nebraska, New York, North Carolina, and Washington).

Each jurisdiction's classification is based on the authors' examination of its rules (generally 1999 or 2000 versions). Copies of the rules are available from the authors on request. Classifications do not reflect differences in enforcement or judicial interpretation.

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⁶⁴ Tennessee would be classified in category 4, on the basis of Tennessee Code of Professional Responsibility Disciplinary Rule 5-103(B) (2000). Classification in category 2B is based on Rule 1.8(e) of proposed Tennessee Rules of Model Conduct (petition to Tennessee Supreme Court to adopt proposed Rules filed by Tennessee Bar Association October 2000, pending July 2001).

⁶⁵ If attorneys do not actually collect loans from losing clients, category 3 is economically equivalent to category 2B.

⁶⁶ If attorneys do not actually collect loans from losing clients, category 4 is economically equivalent to category 2B.

⁶⁷ Maine is classified in category 4 because Bar Rule 3.7(d) (2000) does not state that repayment of advanced litigation expenses may be contingent on the outcome of the matter. However, unlike the other rules classified in this category, it does not expressly state that the client must remain ultimately liable for the expenses.

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