

Comparing Third Party Financing of Litigation and Legal Expenses Insurance

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1. Introduction

For decades there have been some remarkable differences between the US and many European countries with respect to the way lawsuits are funded. For example, in the US neither the federal nor any state government has enacted a statutory right to counsel in civil cases.¹ In Europe, nearly all nations have enacted statutory rights to counsel in criminal and civil cases.² In the US, contingency fees are allowed, and they offer a solution in many cases, especially for plaintiffs with limited financial means. On the contrary, in most European countries contingency fees are not allowed.³ Some recent trends in litigation financing in the US and in Europe seem to have the potential of further increasing the differences in the pattern of litigation funding. In the US, legal expenses insurance for bringing claims is virtually absent⁴, but third-party litigation funding is a growing phenomenon.⁵ Third-party financing of litigation is the “phenomenon of provision of capital by nontraditional sources to civil plaintiffs, defendants, or their lawyers to support litigation-related activities”.⁶ So this term includes financing by others than plaintiffs, defendants,

¹ In the US, private charity was the only source of legal counsel for the poor during most of its history. See Zemans, F., 1979, *Perspectives of Legal Aid*, Frances Pinter, London; Johnson, E. Jr, 1978, *Justice and Reform: The Formative Years of the American Legal Services Program*. Transaction Press, New Brunswick, NJ. Many US states and cities have organized pro bono programs. Others require private lawyers to report on the hours devoted to pro bono services. See Regan, F., Paterson, A., Goriely, T., Fleming, D. (eds.), 1999, *The Transformation of Legal Aid: Comparative and Historical Studies*. Oxford University Press, Oxford, UK. These pro bono legal services only play a limited role in the delivery of access to justice. See Johnson, E. Jr., *Justice, Access to: Legal Representation of the Poor*, in Neil J. Smelser and Paul B. Baltes (eds), *International Encyclopedia of the Social and Behavioral Sciences*, Amsterdam, New York: Elsevier, 2001.

² England’s first statute was enacted in 1495, France in 1852, Germany in 1877 and Italy in 1923. See Johnson, E. Jr., *Justice, Access to: Legal Representation of the Poor*, in Neil J. Smelser and Paul B. Baltes (eds), *International Encyclopedia of the Social and Behavioral Sciences*, Amsterdam, New York: Elsevier, 2001.

³ See for example Michael G. Faure, Fokke J. Fernhout and Niels J. Philipsen, (2010). No cure, no pay and contingency fees. In M. Tuil & L. Visscher (Eds.), *New Trends in Financing Civil Litigation in Europe. A Legal, Empirical and Economic Analysis* (pp. 33-56). Cheltenham: Edward Elgar.

⁴ On the absence of legal expenses insurance for bringing claims in the US, see Matthias Kilian, *Alternatives to public provision: the rule of legal expenses insurance in broadening access to justice: the German experience*, 30 *JOURNAL OF LAW AND SOCIETY*, p. 36, 2003.

⁵ See Rubin, Paul. 2009. *On the Efficiency of Increasing Litigation*. Via <http://www.law.northwestern.edu/searlecenter/papers/Rubin-ThirdPartyFinancingLitigation.pdf>.

⁶ See Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*, RAND Institute for Civil Justice, OP-306-LFCMP, 2010, 66 pp., ISBN: 978-0-8330-4990-2, p. 1.

insurers and lawyers.⁷ Although it is not widespread, it's playing an increasingly visible role. Its recent growth may be explained by a host of factors, including increasing litigation costs, professional-responsibility rules that forbid lawyers to pay the living expenses of their clients while litigation is pending, and the lack of capital to fund litigation in the traditional lending market. In Europe, although many countries still provide legal aid quite generously, some countries have pushed or are seriously thinking about pushing consumers into entering private insurance arrangements to guarantee access to the courts. For example, before 1 December 1997, most Swedes could rely on public legal aid when they needed legal advice or a lawyer to go to court. Since that day however, most Swedes have to rely on their (mandatory) legal expenses insurance policy to have access to legal services.⁸ The UK report "The Market for 'BTE' Legal Expenses Insurance", prepared on behalf of the Ministry of Justice in 2007, concludes that legal insurance is an underexplored means of promoting access to justice. It also offers different suggestions to promote LEI to a broader public.⁹ ¹⁰ Briefly summarized, the trend in Europe reflects an ex ante approach to funding of litigation (LEI), while the trend in the US reflects an ex post approach (TPF).

In this article, we make a comparison between third party financing of litigation and legal expenses insurance from an economic perspective. Such a comparison deserves attention for at least two reasons. First of all, as we will argue, legal expenses insurance is not all that widespread in Europe as is often alleged. In most countries in which legal expenses insurance is not forcefully pushed by the government (e.g. by making it compulsory), legal expenses insurance is

⁷ Lawyer funding is more ubiquitous in the US than in Europe. For an overview of contingency fees in Europe see Michael G. Faure, Fokke J. Fernhout, Niels J. Philipsen, (2010). No cure no pay and contingency fees. In M. Tuil and L. Visscher (Eds.), *New Trends in Financing Civil Litigation in Europe. A legal, empirical and economic analysis* (pp. 33-56). Cheltenham: Edward Elgar.

⁸ See Regan, F. *The Swedish Legal Services Policy Remix: The Shift from Public Legal Aid to Private Legal Expenses Insurance*", (2003) *Journal of Law and Society*, 30(1), 49-65, at p. 50.

⁹ See FWD, 2007, *The Market for 'BTE' Legal Expenses Insurance*, <http://www.justice.gov.uk/publications/docs/market-bte-legal-expenses-insurance-a.pdf>.

¹⁰ LEI is also on the agenda in Canada. Professor Michael Trebilcock wrote: "I conclude that legal insurance may be one means to significantly improve access to justice in Ontario, particularly in civil matters, including family law. The Law Society of Upper Canada and LAO should accord a high priority to promoting the role of legal insurance in Ontario". See Report of the Legal Aid Review 2008, <http://www.attorneygeneral.jus.gov.on.ca/english/about/pubs/trebilcock/section7.asp>.

indeed not that common. This cannot be explained by the possibility of entering into contingency fee contracts, because such contracts are forbidden in most European countries.¹¹ Also, one would expect a large fraction of households to be covered by LEI in those European countries with limited legal aid budgets, but this is not always the case. In Belgium for example, only 20 percent of the population is covered by public legal aid and contingency fees are prohibited. The number of persons having LEI in this country however is quite low.¹² This raises the question whether the market for legal expenses insurance suffers from a market failure, and whether this market failure could also hinder the development of the market for third party financing. We will discuss eight potential reasons: the underestimation of risk, the lack of risk aversion, the existence of alternatives for access to justice, the low probability of a pay-out, insurer ambiguity, adverse selection, moral hazard and the free rider problem. A second reason why a comparison may be interesting is to shed light on the relative social costs of third party financing and legal expenses insurance. The social efficiency of third party financing has been intensely debated in the recent literature. Many advantages and disadvantages have been examined. We will examine to which extent TPF and LEI differ with respect to these advantages and disadvantages. We will look at the volume of litigation, the quality of litigation, the accuracy and likelihood of settlement and the transaction costs of disputes. Such a comparison could help policymakers in deciding whether or not to stimulate third-party financing (e.g. through relaxing some current legal restrictions) and/or legal expenses insurance (e.g. by a tax deduction).

This article unfolds as follows. In section 2, we provide data, facts and legal background for both LEI and TPF. We examine differences between legal expenses insurance in the US and in Europe in greater detail. We will see that there are great differences between the US and Europe, but also between European countries themselves. Legal expenses insurance for bringing a claim is not

¹¹ See International Legal Aid Group Conference (Wellington, New Zealand), National Report Belgium, online via http://www.ilagnet.org/jscripts/tiny_mce/plugins/filemanager/files/Wellington_2009/National_Reports/Belgium_-_SG.pdf.

¹² In 2007 an agreement has been made between the Minister of Justice and the insurance companies to set up a general legal expenses insurance. For a yearly amount of 144 € a person is entitled to legal aid by a lawyer. Only 67,000 persons have subscribed the insurance so far. There are roughly speaking 10 million Belgians. Note that the scope of the legal matters covered by this insurance is rather limited. See International Legal Aid Group Conference (2009). A royal decree of 15 January 2007 has even provided for a tax benefit for those who subscribe to LEI but traditionally LEI coverage in Belgium remains low.

only quite rare in the US (at least in its pure form, see further), but also in many European countries. Furthermore, in those (European) countries in which a large fraction of households have LEI, this is due to the intervention of policymakers. Section 3 examines several potential reasons why LEI markets (and policies) may be underdeveloped. We discuss why most of these reasons cannot fully explain the low prevalence of LEI and analyze whether these factors could hinder the development of TPF. In section 4, we examine the advantages and disadvantages of the ex ante approach (LEI) and the ex post approach (TPF). Section 5 concludes.

2. LEI and TPF in the US and in Europe: legal framework, facts and data

2.1. LEI

2.1.1. General remarks

Legal expenses insurance is a voluntary private insurance which covers the costs of lawsuits. This type of insurance is also known as legal cost insurance, legal protection insurance or simply legal insurance.¹³ In France, legal expenses insurance is called “L’assurance de protection juridique”, in Germany “Rechtsschutzversicherung”. Directive 87/344/EEC of 22 June 1987 of the European Union on the coordination of laws, regulations and administrative provisions relating to legal expenses insurance¹⁴ uses the term legal expenses insurance, and defines this type of insurance as follows: “Such consists in undertaking, against the payment of a premium, to bear the costs of legal proceedings and to provide other services directly linked to insurance cover, in particular with a view to (a) securing compensation for the loss, damage or injury suffered by the insured person, by settlement out of court or through civil or criminal proceedings, (b) defending or representing the insured person in civil, criminal, administrative or other proceeding or in respect of any claim made against him”. In this article, we focus on legal expenses insurance for *bringing* claims. In contrast to legal expenses insurance for bringing claims, legal expenses insurance for

¹³ See T. Raiser, “Legal Insurance”, in Neil J. Smelser and Paul B. Baltes (eds), *International Encyclopedia of the Social and Behavioral Sciences*, Amsterdam, New York: Elsevier, 2001, p. 8638

¹⁴ OJ L 185 of 04.07.1987.

defending against claims is almost always part of liability insurance contracts. Furthermore, we focus on *before the event* (BTE) legal expenses insurance and not on *after the event* (ATE) legal expenses insurance. BTE legal expenses insurance is taken out by those wishing to protect themselves against the potential litigation costs, which could be incurred following a future event. ATE legal expenses insurance covers future legal expenses in a case where a dispute has already occurred, such as an accident which has caused an injury.¹⁵ We also need to distinguish between *add-on* legal expenses insurance and *stand-alone* legal expenses insurance. The former is added on to existing policies that already have a high market penetration, like household insurance and motor vehicle insurance.¹⁶ Stand alone legal expenses insurance policies however are concluded separately from any other insurance agreement. Most current LEI policies are of the add-on type.¹⁷ Finally, a distinction can be made between *pure forms* of legal expenses insurance and *legal services plans*. The pure form of LEI originated in Europe, and it still dominates there. It applies insurance principles similar to other forms of insurance. In that case LEI is a means of financing the often unpredictable costs of civil lawsuits. The LEI policy spreads the risk of these costs among all policy holders. Legal services plans do not use insurance principles but create benefits for policy holders by relying on bulk savings. These plans are found mainly in the US and Canada.¹⁸

2.1.2. United States

In the United States, we need to distinguish between group legal services plans and prepaid legal services plans. Group legal services plans usually offer free consultations and discounts on legal

¹⁵ See Matthias Kilian, Alternatives to public provision: the rule of legal expenses insurance in broadening access to justice: the German experience, 30 JOURNAL OF LAW AND SOCIETY, 31-33, (2003). Note that ATE insurance is likely to be available only when the chances of winning the case are high. Otherwise an insurer could not ensure profit.

¹⁶ See Francis Regan, Whatever happened to legal expenses insurance? 26 ALTERNATIVE LAW JOURNAL 293,294 (2001), p. 294.

¹⁷ See RIAD (International Association of Legal Expenses Insurance), 2010. “The Legal Protection Insurance Market in Europe”, p. 14, via http://www.riad-online.net/fileadmin/documents/homepage/publications/Annual_Reports/RIAD-Legal-Protection-Market_June2010.pdf.

¹⁸ See Francis Regan, Whatever happened to legal expenses insurance? 26 ALTERNATIVE LAW JOURNAL 293,294 (2001).

services to members of groups that sponsor the plans (e.g. unions and membership organizations like the AARP).¹⁹ The members generally only pay the membership fee to join the group, and no fees for accessing the legal services. The discounts are based on the usual fees of the participating lawyers. In 2002, four plans accounted for more than ninety percent of those covered by the group plans: the Union Plus Legal Services Plan (45%), the AARP plan (20%)²⁰, the elder hotlines (20%) and the plan sponsored by the National Education Association (6%).²¹ Prepaid legal services plans are generally sold by companies who contract with lawyers in private practices to provide the services. The larger union plans however offer counseling mainly through their own employees. These employees may be attorneys, but they often have no or little official legal education.²² Most prepaid plans are either offered as an employee benefit (funded by employers), or sold directly to employees through their employers at special rates, or sold directly to the public.²³ In general, the plans are limited in scope and only provide low-cost assistance for routine legal matters.²⁴ For example, members of AARP receive up to 45 minutes free consultation, low cost simple wills and powers of attorneys, and a 20% discount on all other services provided by its participating attorneys.²⁵ In 1999, approximately 110 million Americans were estimated to be covered by some type of legal coverage (personal, business, union, military

¹⁹ See Moore, Wayne, *The Impact of Group and Prepaid Legal Services: Plans to Meet the Needs of Middle Income People*, Ilag Conference Paper, Harvard, 2003.

²⁰ AARP stands for American Association of Retired Persons.

²¹ See Moore, Wayne, *The Impact of Group and Prepaid Legal Services: Plans to Meet the Needs of Middle Income People*, Ilag Conference Paper, Harvard, 2003, at pg 7.

²² T. Raiser, "Legal Insurance", in Neil J. Smelser and Paul B. Baltes (eds), *International Encyclopedia of the Social and Behavioral Sciences*, Amsterdam, New York: Elsevier, 2001 p. 8639.

²³ See Moore, Wayne, *The Impact of Group and Prepaid Legal Services: Plans to Meet the Needs of Middle Income People*, Ilag Conference Paper, Harvard, 2003.

²⁴ DONALD L. CARPER, BILL W. WEST, JOHN A. MCKINSEY. 2008. *UNDERSTANDING THE LAW*. Mason, Ohio: Thomson/West, p. 157.

²⁵ See <http://www.aarp.org/benefits-discounts/discounts/services/info-2010/legal-services-network.html>.

or employee) plan.²⁶ In 2002, 122 million Americans were covered by group (68 million) and prepaid (54 million) legal services plans.^{27 28}

2.1.3. Europe

The main obligations on insurance undertakings that offer legal expenses insurance in EU countries can be found in Directive 87/344/EEC of 22 June 1987 of the European Union on the coordination of laws, regulations and administrative provisions relating to legal expenses insurance.²⁹ National regulations, apart from the ones implementing this directive, generally do not contain many specific provisions dealing with legal expenses insurance.³⁰ First, insurance undertakings need to provide a separate contract or a separate section of a single policy for legal expenses insurance. Second, to mitigate the risk of conflicts of interest, insurance undertakings either have (a) to have separate management for legal expenses insurance, or (b) to entrust the management of claims in respect of legal expenses insurance to an undertaking having separate legal identity; or (c) to afford the insured person the right to entrust the defence of his interests, from the moment that he has the right to claim from his insurer under the policy, to a lawyer of his choice. In all cases the insured must have the right to choose his lawyer where recourse is had to a lawyer. Finally, in the event of a conflict of interest or a disagreement over settlement of the dispute, the insurer must inform the insured person of his right to choose his lawyer freely and of the possibility of using an arbitration procedure. With respect to mass claim actions, the ECJ recently had to decide whether clauses that entitle insurers, where the interests of several insured persons are directed against the same opponents, to limit its performance to the bringing of test cases, or where appropriate, to collective redress or other ways of asserting legal interests by

²⁶ See Clarke, Canfield, Lawyers To Go: Some Mainers Are Taking Care of Their Legal Needs Trough Prepaid Services, PORTLAND PRESS HERALD, Apr. 27, 1999, at C1. The figures were gathered by the National Resource Center for Consumers of Legal Services.

²⁷ 2002 Legal Services Plan Census, National Resource Center for Consumers of Legal Services, 2002, pg 1, www.nrccls.org.

²⁸ The figure equals 154 million if duplicates are counted.

²⁹ OJ L 185 of 04.07.1987.

³⁰ See for example for the UK, FWD, 2007, The Market for 'BTE' Legal Expenses Insurance, <http://www.justice.gov.uk/publications/docs/market-bte-legal-expenses-insurance-a.pdf>, p. 48.

legal representatives selected by it, are an admissible limitation of the rights of the insured.³¹ The ECJ ruled that they are not.

Turning from the legal framework to facts and data, we start with the UK. Before-the-event insurance has been available in the UK for more than 35 years.³² LEI is sold in a variety of ways. First and foremost, it is sold by insurance companies as an add-on to motor or household insurance. In other words, it is an optional policy. Only some insurers incorporate it in the household policy so that it is not an option with a separate charge. In 2005, 75 % of all households had home contents insurance.³³ Many people do not take the option however. LEI is not only sold directly by insurance companies, but also through banks and building societies. It can also be attached to travel insurance. For employment matters, people sometimes have access to LEI through membership of a trade union or other affinity groups. LEI is often sold through intermediaries: national brokers, broker chains and smaller regional brokers. The UK market is dominated by add-on policies. The penetration rate of comprehensive stand-alone covers remains low (about 2 % of households³⁴), with the exception of commercial policies. With respect to add-ons, more households take LEI as an add-on to motor insurance rather than to household insurance. In 2006, about 18.5 million consumers held LEI as part of their car insurance, 14.2 million people bought LEI as an add-on to their household insurance and 4.7 million purchased LEI with their travel insurance.³⁵ The estimated UK population is about 62 million. LEI as an add-on to household insurance offers more extensive coverage than the (standard) add-on to a motor policy.³⁶ A LEI policy added on to household insurance generally covers personal injury,

³¹ ECJ 10.9.2009, C-199/08, Eschig v Uniqia.

³² FWD, 2007, The Market for 'BTE' Legal Expenses Insurance, <http://www.justice.gov.uk/publications/docs/market-bte-legal-expenses-insurance-a.pdf>, p. 9.

³³ FWD, 2007, The Market for 'BTE' Legal Expenses Insurance, <http://www.justice.gov.uk/publications/docs/market-bte-legal-expenses-insurance-a.pdf>, p. 11.

³⁴ FWD, 2007, The Market for 'BTE' Legal Expenses Insurance, <http://www.justice.gov.uk/publications/docs/market-bte-legal-expenses-insurance-a.pdf>, p. 39.

³⁵ FWD, 2007, The Market for 'BTE' Legal Expenses Insurance, <http://www.justice.gov.uk/publications/docs/market-bte-legal-expenses-insurance-a.pdf>, p. 12.

³⁶ FWD, 2007, The Market for 'BTE' Legal Expenses Insurance, <http://www.justice.gov.uk/publications/docs/market-bte-legal-expenses-insurance-a.pdf>, p. 12.

property protection, tax protection, employment disputes, contract disputes and certain aspects of legal defence. Via add-ons to motor insurance policies, claim handlers enable individuals to recover from third parties any uninsured losses or compensation for personal injury following a motor accident. The types of claims that typically occur under a personal LEI policy are: personal injury (50%), consumer disputes (16%), employment disputes (20%), property disputes (8%) and medical negligence (6%).³⁷ The policy limits are not always very high.

France was the first European country in which LEI³⁸ products were offered.³⁹ ⁴⁰ In 2008, there were 5.4 million stand-alone LEI contracts with an average premium of 62 Euro and 15 million LEI policies added-on to general household insurance with an average premium of 20 Euro (for the add-on).⁴¹ ⁴² The low average premiums, together with the fact that LEI only provided for 2.5 % of the income of lawyers and that in only 2% of French court cases the plaintiff has some form of legal expenses insurance, show that the economic importance of LEI in France is very modest.⁴³

The German market for legal expenses insurance is dominated by stand-alone policies. Most policies do not cover all domains of law. The policyholder is free to mix several modules according to her needs (e.g. 'property law', 'contract law', 'employment law').⁴⁴ The

³⁷ FWD, 2007, The Market for 'BTE' Legal Expenses Insurance, <http://www.justice.gov.uk/publications/docs/market-bte-legal-expenses-insurance-a.pdf>, p. 47.

³⁸ In France, legal expenses insurance is referred to as « Assurance de Protection Juridique ». For details see Cerveau, B., L'Assurance de Protection Juridique, Marché, Garanties, Perspectives, L'Argus de l'Assurance 2006.

³⁹ Since 1905, see Kilian, M. 1999. Determinanten des europäischen Rechtsschutzversicherungsmarktes, Zeitschrift für die Gesamte Versicherungswissenschaft.

⁴⁰ LEI is regulated through the Loi Portant Réforme de l'Assurance de Protection Juridique of 19th of February 2007.

⁴¹ See Cerveau, Bernard, Aide Juridictionnelle et Assurance de Protection Juridique, via http://www.avocats-lille.com/doc/aj/AJ_assurance_protection_juridique.pdf.

⁴² In 2005, 21 percent of households had legal expenses insurance. See Beaulieu, M.-H. and Lauzon, J., L'assurance juridique: une solution pour une meilleure accessibilité à la justice?, via http://www.option-consommateurs.org/documents/principal/fr/File/rapports/assurances/oc_assurance_juridique_200704.pdf.

⁴³ 360.000 cases were opened, 60.000 ended up in court. See Cerveau, Bernard, Aide Juridictionnelle et Assurance de Protection Juridique, via http://www.avocats-lille.com/doc/aj/AJ_assurance_protection_juridique.pdf.

⁴⁴ Matthias Kilian, Alternatives to public provision: the rule of legal expenses insurance in broadening access to justice: the German experience, 30 JOURNAL OF LAW AND SOCIETY, 2003. p. 34..

policies do not cover abstract legal advice (an insured event must occur first).⁴⁵ Given the extensive monopoly rights for lawyers in Germany, cases are not dealt with by in-house lawyers. Routine transactions such as legal advice and assistance with documents are rarely covered. In 2000, 42 % of households were covered⁴⁶, in 2004 a coverage of 44% was reported.⁴⁷

In the early 1970s, Sweden introduced one of the most comprehensive and generous legal aid schemes in the world. Legal aid was available for most legal problems including advice and assistance related to litigation. The legal aid scheme included most of the population.⁴⁸ In 1997 the Swedish government radically reformed its legal services policy. Public expenditures on legal aid were drastically cut. The relationship between public legal aid and private forms of financing legal assistance was reversed. Since 1 December 1997 most Swedes have to use their legal expenses insurance policy to get access to legal services.⁴⁹ A special feature of LEI in Sweden is that cover for legal expenses is automatically included in household policies. 97% of Swedes are reported to be covered by LEI.⁵⁰

Recent data provided by the Comité Européen des Assurances (CEA) show that LEI represented only 1% of total European insurance premiums in 2008.⁵¹ The CEA data also show the evolution of LEI premia income between 2000 and 2008 for several European countries. On

⁴⁵ See van Bühren, H., 'Das rechtsschutzversicherte Mandat', 1998, 52 *Monatsschrift für Deutsches Recht* 745, at. 748.

⁴⁶ The figure is for the year 2000. See Kilian, M., "Alternatives to Public Provision: The Role of Legal Expenses Insurance in Broadening Access to Justice: The German Experience", *Journal of Law and Society*, 2003, Vol. 30, p. 31-48.

⁴⁷ See Kilian, M. and Reagan, F., "Legal Expenses Insurance and Legal Aid – Two Sides of the Same Coin? The Experience from Germany and Sweden", *International Journal of the Legal Profession*, 2004, vol. 11 (3), 238.

⁴⁸ See Regan, F. 'The Swedish Legal Services Policy Remix: The Shift from Public Legal Aid to Private Legal Expenses Insurance', (2003) *Journal of Law and Society*, 30(1), 49-65, at p. 52; see also Bruzelius, A. and Bolding, P.O., 'An Introduction to the Swedish public legal aid reform', in *Towards Equal Justice: A Comparative Study of Legal Aid in Modern Societies*, eds. M. Capelletti et al. (1975)).

⁴⁹ Regan, F. 'The Swedish Legal Services Policy Remix: The Shift from Public Legal Aid to Private Legal Expenses Insurance', (2003) *Journal of Law and Society*, 30(1), 49-65, at p. 50.

⁵⁰ See Van Zeelandt, C. and Barendrecht, J.M., *Legal Aid Systems Compared*, 2003, online via <http://www.tilburguniversity.nl/faculties/law/research/tisco/publications/reports/legal-aid-systems.pdf>.

⁵¹ See CEA statistics nr. 37, 2009, via <http://www.cea.eu/uploads/Modules/Publications%5Ceif-2009.pdf>.

the basis of these data, we can see that LEI is becoming more widespread in Europe, but also that in absolute terms, its importance remains modest.

Country	Premium income per capita 2008 (Euro)⁵²	Premium income per capita 2000 (Euro)
Austria	47.98	33.78
Belgium	31.73	21.89
Germany	38.97	32.71
Spain	3.97	1.86
Finland	10.37	5.84
France	11.47	6.06
Italy	4.79	2.11
Netherlands	41.33	15.87
Poland	9.83	2.19
United Kingdom	11.76	2.90

2.1.4. Discussion

At first sight, the differences between legal expenses insurance in the US and in Europe couldn't be greater. The US legal plans are not truly insurance policies and only cover a limited amount of services. The European policies seem much broader. On closer inspection, the differences should not be exaggerated for two reasons. First, there are many European countries where LEI is virtually absent. Second, some of the European data need to be put in perspective. With the Swedish and the German data in mind, one could argue that insurance markets for legal

⁵² Note that premium income per capita can not be easily translated into the percentage of households that have LEI in a given country. The premium income per capita may also be misleading, since LEI policies can vary from very broad (covering all kinds of legal cases) to very narrow (e.g. covering only motor accident cases).

services do not face any inherent problem to develop. However, as we have explained before, Swedish LEI policies are automatically added to another insurance policy which already has a large market penetration (household insurance). Swedes do not have the possibility to take household insurance without LEI.⁵³ LEI is integrated in that policy "for free".

Also, LEI policies restrict assistance to a rather narrow range of court cases. This can be explained historically. The labour movement promoted LEI in the 1960s because legal aid would be inadequate, especially for middle-income earners. LEI was designed to cover problems, costs and groups that were excluded from legal aid. These policies were rather modest, since legal aid was quite comprehensive. Furthermore, the 1997 reforms did not put any pressure on insurance companies to expand the insurance cover offered under LEI. Finally, claims on LEI require policyholders to pay an upfront fee and a fraction of the estimated costs of the case. There is also a ceiling on the amount that can be claimed per year.⁵⁴

Regarding Germany, it needs to be said that other non-compulsory insurances are even much more popular than LEI. For example, an estimated 65 percent of all households have a general liability insurance and 75 percent have a household insurance.⁵⁵ Research by Kilian (2003) shows that we should expect the demand for LEI to be high in Germany, since the regulatory environment there is very favorable for the development of this insurance market⁵⁶: (1) the German government only spends a modest amount on legal aid, (2) almost all forms of output-based remuneration are prohibited; the prohibition included not only contingent fees, but also

⁵³ The Swedish model is hence what is referred to as compulsory add-on insurance: in addition to voluntarily purchased insurances, LEI is automatically added-on to other insurance policies with a high market penetration. LEI in Sweden is supposedly added "for free" but since it is automatically added on to the household insurance the reality is rather that the price for LEI is included in the premium for the basic insurance. It is hence obviously not "free" but simply not directly visible. See Regan, F., "Whatever happened to legal expenses insurance?", *Alternative Law Journal*, 2001, Vol. 26, p. 293-297. See also Regan, F., "The Swedish Legal Services Policy Remix: The Shift from Public Legal Aid to Private Legal Expenses Insurance", *Journal of Law and Society*, 2003, p. 49-65.

⁵⁴ In 2002, the upfront fee was 110 Euro, the fraction 20% and the ceiling 11.007 Euro.

⁵⁵ Kilian, M., "Alternatives to Public Provision: The Role of Legal Expenses Insurance in Broadening Access to Justice: The German Experience", *Journal of Law and Society*, 2003, Vol. 30, p. 38.

⁵⁶ Kilian, M., "Alternatives to Public Provision: The Role of Legal Expenses Insurance in Broadening Access to Justice: The German Experience", *Journal of Law and Society*, 2003, Vol. 30, p. 31-48.

conditional fees and success fees⁵⁷, (3) even a party enjoying legal aid who loses her claim has to pay her opponents' costs herself. Only her own lawyer's and court fees are covered by legal aid, (4) lawyers enjoy monopoly rights for out of court work (and not just for representation in court), making it virtually impossible to obtain lower cost legal advice by non-lawyers, (5) the existence of a very formal and transparent fee regulation, laid down in the Bundesrechtsanwaltsgebührenordnung (BRAGO, German Federal Code of Lawyers' Fees), gives insurance companies a good idea of the ultimate risk, which makes calculation of premiums not very difficult, and last (6) the German Bar has very little reason to oppose a shift from public legal aid to private insurance. Indeed, in countries where the interest of the Bar is sufficiently protected by the regulatory environment, the Bar has generally not opposed government efforts to shift the emphasis from public aid to private insurance. Whether we can expect the Bar to oppose the development of LEI mainly depends on the following three factors: (1) Whether lawyers enjoy monopoly rights not only for representation in court, but also for out of court work. If lawyers only enjoy monopoly rights for representation in court, they have more to lose when legal expenses insurance becomes more popular. This means that insurance companies then can handle a large fraction of the cases (the relatively simple ones) themselves, without having to hire a lawyer. In the Netherlands for example insurance companies handle around 98 percent of the cases in-house.⁵⁸ (2) Whether the insured can freely choose the lawyer that will handle their case. When insurance companies do need to hire a lawyer (because they have to or they don't but the case is complex or a settlement can not be reached), the insurance company has a natural incentive to keep costs under control, unlike a lawyer that is paid on an hourly basis. If the insured can choose his lawyer freely, this eliminates or at least reduces the possibility for

⁵⁷ The system has been changed since the 1st of July 2008 as a result of a decision of the Bundesverfassungsgericht of 12 December 2006, 1 BVR 2576/04 where the Bundesverfassungsgericht held that the unconditional prohibition of a Erfolgshonorar (success fee) violated article 12 of the constitution (Grundgesetz), guaranteeing a free exercise of the profession. Now article 49b § 2 BRAO (Bundesrechtsanwaltsordnung, The Rules and Regulations for the German Bar) holds that deviations from the prohibition can be provided for in the RVG (Rechtsanwaltsvergütungsgesetz, attorney remuneration law). The exception holds that output based remuneration systems are hence forth allowed if this is the only way to provide access to justice to a citizen (for details see Faure, M.G., Fernhout, F.J. and Philipsen, N.J., Resultaatgerelateerde Beloningssystemen voor Advocaten, WODC, Dutch Ministry of Safety and Justice, via <http://wodc.nl/onderzoeksdatabase/internationale-vergelijking-beloningssystemen-advocatuur.aspx>, p. 49-50).

⁵⁸ See Faure, M., Hartlief, T. & Philipsen, N., "Funding of Personal Injury Litigation and Claims Culture. Evidence from the Netherlands", Utrecht Law Review, no. 2, 2006. Available at <http://www.utrechtlawreview.org/index.php/ulr/article/viewFile/23/23>.

insurance companies to create competition between different lawyers (and law firms).⁵⁹ (3) Whether the government introduced and enforces minimum fees for lawyers. Even when insurance companies can force a lawyer upon the insured, competition between lawyers will never lead to lower than minimum fees when the government enforces minimum fee rules. Not surprisingly, lawyers in Germany have not really opposed the expansion of the legal expenses insurance industry, since lawyers enjoy monopoly rights for out of court work, clients are free to choose their own lawyer and minimum fees apply.⁶⁰

2.2. TPF in the United States⁶¹

The current TPF industry in the United States can be divided into three relatively active segments: (1) consumer legal funding (non-recourse loans) to individual, usually personal-injury plaintiffs, (2) loans and lines of credit for plaintiffs' law firms, and (3) investments in commercial (business against business) lawsuits.⁶² These segments have in common that they provide financial support for plaintiff-side efforts.⁶³ At the present time, there is very little TPF for

⁵⁹ Council Directive 87/344EEC of 22 June 1987 on the coordination of laws, regulations and administrative provisions relating to legal expenses insurance (OJ L 185 of 4 July 1987) explicitly provides in article 4 that any contract of legal expenses insurance has to recognize explicitly that the insured person shall be free to choose a lawyer.

⁶⁰ See Kilian, M., "Alternatives to Public Provision: The Role of Legal Expenses Insurance in Broadening Access to Justice: The German Experience", *Journal of Law and Society*, 2003, Vol. 30, p. 31-48.

⁶¹ This section briefly describes the TPF industry and its regulatory environment in the United States. For more elaborate studies and for a description of TPF in other countries, we refer to the other articles in this issue.

⁶² Because of time and space constraints, we focus on the main forms of TPF in the US and do not discuss (for example) the case of the purchase of retroactive liability coverage. For example, when fire hit the MGM Grand Hotel in Las Vegas in 1980, the hotel's owners had only \$30 million in liability insurance. After the fire, the hotel company increased its liability coverage to almost \$200 million. This new insurance was backdated to 20 days before the catastrophe. This can be explained by a comparative advantage in claims administration. See Mayers, D. and Smith, C. 1982. *On the Corporate Demand for Insurance*. *The Journal of Business*, p. 285. Without the extra coverage, the incentives of the insurance company's adjusters' to negotiate efficient settlements could be far from optimal.

⁶³ See Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*, RAND Institute for Civil Justice, OP-306-LFCMP, 2010, 66 pp., ISBN: 978-0-8330-4990-2, p. x.

defendants⁶⁴, although some providers of plaintiff-side TPF are also interested in providing funding to defendants and their lawyers.⁶⁵ For now, third party funding does not seem to play an important role in the US class action market.⁶⁶ A number of investment firms have claimed that they do not intend to enter the US class action market.⁶⁷ In the context of consumer legal funding, a consumer's potential recovery from a class action may seldom be large enough for obtaining a non-recourse loan. Nowadays, personal-injury class actions are not often certified.⁶⁸

Regarding consumer legal funding⁶⁹, in 2010 several dozens of TPF companies provided funding to consumers with pending legal claims.⁷⁰ Since the great majority of these lawsuits involve personal-injury claims (mainly auto accidents) and given that only consumers who have found a lawyer who has agreed to represent the client are eligible for funding, it's fair to say that almost all of these consumers are being represented on a contingency-fee basis. Typically, the TPF company provides funds to the consumer in exchange for a promise to pay back the funds plus a contracted fee. The fee does not depend on the amount of the recovery, but typically increases with the time elapsed.⁷¹ The contracts are typically non-recourse loans, meaning that a consumer is never obligated to pay more than the proceeds from the underlying lawsuit. The financing fees

⁶⁴ Theoretically, this could be due to several reasons: the unlimited downside litigation risk of defendants, adverse selection, moral hazard, the fact that defendants and their lawyers may have better access to capital than individual plaintiffs and their lawyers and the fact that many corporate defendants have insurance that covers legal expenses (e.g. general liability insurance). See Molot, Jonathan T., "A Market in Litigation Risk", *University of Chicago Law Review*, Vol. 76, 2009, pp. 367-440.

⁶⁵ See Lindeman, Ralph, "Third-Party Investors Offer New Funding Source for Major Commercial Lawsuits", *Daily Reports for Executives* (Bureau of National Affairs), March 5, 2010, p. 3.

⁶⁶ See Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*, RAND Institute for Civil Justice, OP-306-LFCMP, 2010, 66 pp., ISBN: 978-0-8330-4990-2, p. 36.

⁶⁷ Hensler, Deborah R., *The Future of Mass Litigation: Global Class Actions and Third-Party Litigation Funding*, *The George Washington Law Review*, p. 323.

⁶⁸ Muehlberger, James P., and Nicholas P. Mizell, "Certification Claims Come Under Tighter Scrutiny", *National Law Journal*, December 4, 2006.

⁶⁹ Many other terms besides consumer legal funding are used by TPF companies and others: e.g. cash advances, legal funding and plaintiff funding.

⁷⁰ Some contracts are made after the case is settled. The reason is that it can take months before the settlement payment is made.

⁷¹ See Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*, RAND Institute for Civil Justice, OP-306-LFCMP, 2010, 66 pp., ISBN: 978-0-8330-4990-2, p. 9.

can significantly exceed interest rates on consumer bank loans or credit card balances. Typical rates would be 3 to 5 % monthly interest⁷², although some companies charge less than 2 %. The average size of the cash advance tends to be less than 10 percent of estimated values of the underlying claim.⁷³ Consumers may be interested in these loans because their ability to obtain funding from other sources is exhausted, or because they like the fact that they never have to pay back more than the proceeds of the lawsuit.

Unlike for consumer legal funding, loans to plaintiffs' law firms are not non-recourse.⁷⁴ The debts of law firms are typically secured by all the assets of the firms, including real property and future fees from their cases. Little is known about the interest rates charged, but interest rates of about 20 percent seem not to be uncommon. The main motives of law firms to use this type of funding are the desire to remain solvent, alleviate cash-flow problems, compete for business with law firms that have more capital and invest more in pending cases.⁷⁵

Garber (2010) identified 6 companies that provide capital directly to businesses-plaintiffs or their outside counsel to finance costs of pending commercial claims (business-against-business).⁷⁶ The disputes are usually antitrust, intellectual property or contracts cases. The TPF companies provide capital in return for a share of the recovery by the corporate plaintiff, hence the term *investment* for these transactions. Several motives have been advanced why companies consider this type of

⁷² See Molot, Jonathan T., "A Market Approach to Litigation Accuracy," 2009b, paper presented at "Third Party Litigation Funding and Claim Transfer—Trends and Implications for the Civil Justice System," RAND Institute for Civil Justice and UCLA Law policy symposium, RAND Corporation, June 2, 2009; Searle Public Policy Roundtable on Third Party Financing of Litigation, Northwestern University Law School, Chicago, Ill., September 24–25, 2009; and U.S. Chamber Institute for Legal Reform, 10th Annual Legal Reform Summit, Washington, D.C., October 28, 2009, p. 24.

⁷³ See Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*, RAND Institute for Civil Justice, OP-306-LFCMP, 2010, 66 pp., ISBN: 978-0-8330-4990-2, p. 12.

⁷⁴ In 2010, Garber identified 9 TPF companies in this segment. See Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*, RAND Institute for Civil Justice, OP-306-LFCMP, 2010, 66 pp., ISBN: 978-0-8330-4990-2, p. 13.

⁷⁵ See Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*, RAND Institute for Civil Justice, OP-306-LFCMP, 2010, 66 pp., ISBN: 978-0-8330-4990-2, p. 13 and 23.

⁷⁶ See Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*, RAND Institute for Civil Justice, OP-306-LFCMP, 2010, 66 pp., ISBN: 978-0-8330-4990-2, p. 13.

funding. Some companies may want to use less of their own capital to pay (outside) counsel. Others may want an assessment of the merits and economic value of their claim additional to the one provided by their outside counsel. Next, some companies might use TPF strategically in the hope of strengthening their bargaining position. The provision of TPF could signal that the claim is of high merit to the defendant. And last, corporate general counsel may be loathe to ask for a budget increase.

The legal status of third-party financing in the United States is quite unclear.⁷⁷ Laws governing TPF agreements vary widely amongst states. Only a few states have adopted regulations *specifically* for TPF.⁷⁸ These statutes generally focus on loans in personal injury cases, not on commercial litigation. In the context of commercial litigation, no US court has yet considered the legality of TPF.⁷⁹ With respect to loan agreements in personal injury suits, caselaw is mixed. Many courts have held these agreements valid and enforceable.⁸⁰ Some other courts however have invalidated these agreements.⁸¹ The most frequently cited criticism is that these agreements violate the common law doctrines of maintenance and champerty. Maintenance is the interference in litigation by those without a legitimate interest in the claim. Champerty is maintenance by those who seek to profit from another's lawsuit.⁸² Although there have been few prosecutions in the last century, the doctrines are still considered valid in the US. By contrast, in Australia for

⁷⁷ See Jason Lyon, *Revolution in Progress: Third-Party Funding of American Litigation*, 58 *UCLA Law Review*, 2010, p. 575.

⁷⁸ Maine, Nebraska and Ohio enacted specific legislation. See *Maine Consumer Credit Code Legal Funding Practices*, ME. REV. STAT. tit. 9-A, § 12 (2009); *Nebraska Nonrecourse Civil Litigation Act*, NEB. REV. STAT. ANN., § 25-3303 (West 2010); *Non-Recourse Civil Litigation Advances*, OHIO REV. CODE ANN. tit. 13, § 1349.55 (West 2008).

⁷⁹ See Jason Lyon, *Revolution in Progress: Third-Party Funding of American Litigation*, 58 *UCLA Law Review*, 2010, p. 575.

⁸⁰ See, e.g., *Saladini v. Righellis*, 687 N.E.2d 1224 (Mass. 1997); *Osprey v. Cabana*, 532 S.E.2d 269 (S.C. 2000).

⁸¹ *Rancman v. Interim Settlement Funding Corp.*, 789 N.E.2d 217, 219 (Ohio 2003) (declining to enforce a litigation lending agreement because “a lawsuit is not an investment vehicle” and “[a]n intermeddler is not permitted to gorge upon the fruits of litigation”); cf. *Odell v. Legal Bucks*, L.L.C. 665 S.E.2d 767 (N.C. Ct. App. 2008).

⁸² The US Supreme Court defines maintenance as “helping another prosecute a suit”, and champerty as “maintaining a suit in return for a financial interest in the outcome”. See *In re Primus*, 436 U.S. 412, 424–25 n.15 (1978).

example, some states have abolished these doctrines (e.g. Victoria, New South Wales, Australian Capital Territory and South Australia).⁸³

3. Potential reasons for a low LEI frequency and their influence on TPF

The data in section 2 show that the frequency of purchasing legal expenses insurance is relatively low in many countries. In this section we examine several potential explanations for this phenomenon. We discuss the plausibility of each explanation, and where available, we use empirical research in support. We then analyze whether these explanations may influence the development of TPF.

3.1. Underestimation of risk

3.1.1. LEI

A first reason for a low demand for LEI may be the classic market failure of information asymmetry.⁸⁴ Citizens may generally underestimate the risk of being involved in a lawsuit as well as the costs involved. Moreover, the advantages of LEI could to a large extent not be known to the public at large. This explanation (asymmetry of information) is also advanced to explain underinsurance in a different domain, being that of disaster insurance.⁸⁵ Also there demand is remarkably low even though it can be argued that *ex ante* insurance would increase expected

⁸³ See Chen, Daniel L. and Abrams, David S., *A Market for Justice: The Effect of Third Party Litigation Funding on Legal Outcomes*, 2011.

⁸⁴ See generally on information failures as justification for regulation Schwartz, A. and Wilde, L., “Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis”, *University of Pennsylvania Law Review*, 1979, 630-682.

⁸⁵ See Slovic, P., Kunreuther, H. and White, G.F., “Decision Processes, Rationality and Adjustment to Natural Hazards” in Slovic, P. (ed.), *The Perception of Risk*, London: Earthscan Publications 2000, 1-31, see especially p. 7.

utility. The literature holds that citizens generally underestimate the risk and assume an “it will not happen to me” attitude.⁸⁶ A variety of behavioural explanations have been presented for this phenomenon. People may suffer from so-called “probability neglect”: if the chances of an event are sufficiently low, people do not even reflect on its consequences.⁸⁷ Also bounded rationality (pointing at the cognitive limitations of decision-makers) may explain a low demand since potential victims are insufficiently aware of the risks they are facing.⁸⁸ To some extent these phenomena may play a role in the context of LEI. Individuals may underestimate the probability of being involved in a lawsuit and suffer from cognitive limitations in visualizing this probability. However, those risks are far more serious in the case of hard to imagine events like e.g. an earthquake or a tsunami than in the case of access to justice. It may be difficult for victims to estimate the precise likelihood of ever needing access to justice, but unlike in the case of a natural catastrophe the probability is not that low that one can argue that people will assume the probability to be zero. Empirical studies point out that a large fraction of people encounters legal problems on a regular basis. A Dutch study for example showed that 67 percent of individuals in the Netherlands encountered at least one legal problem (or potential legal problem) in a period of 5 years (1998-2003). Most problems were related to the delivery of products and services, work, money problems and real estate.⁸⁹ Hence, even though the underestimation of risk may play a role in a reduced demand for LEI, it cannot provide a complete explanation. Differently than with disasters, there is less likelihood that behavioural biases like the probability neglect and bounded rationality play a role in the context of LEI.

3.1.2. TPF

⁸⁶ Kunreuther, H.C. et al., *Disaster Insurance Protection: Public Policy Lessons*, New York: John Wiley and Sons Inc. 1978, p. 248.

⁸⁷ See Daniel Kahneman and Amos Tversky, *Prospect theory: an analysis of decision-making under risk* 47, *ECONOMETRICA* 263, 274 (1979).

⁸⁸ Michael Faure and Veronique Bruggeman, *Catastrophic risks and first party insurance*, 15 *CONNECTICUT INSURANCE LAW JOURNAL* 1, 22, 23 (2008).

⁸⁹ Van Velthoven, B. and ter Voert, M., *Geschilbeslechtigingsdelta 2003*, Boom Juridische Uitgevers, 241 p.

The underestimation of risk is unlikely to be a major problem for the development of third-party financing of litigation, since TPF only occurs *after a detrimental event has occurred*. Hence, there is no longer uncertainty as to whether one will be involved in a dispute. There is still uncertainty but this rather concerns whether the plaintiff will be able to win the case. Of course, some individuals may decide not to make use of TPF because they underestimate the costs of litigation (giving them the impression that they are financially able to handle the problem themselves), or because they think the case will settle quickly or get resolved soon by the courts (giving them the impression that it will not take long before their losses will be covered). However, it's highly unlikely that that this will have a major influence on the development of TPF. In most European countries, people generally regard the costs of litigation as high or even excessive⁹⁰, and it is generally well known that trials and settlements can take a long time. The reason TPF is taken often has to do with financing the litigation and hence the underestimation of the risk is not the main issue for TPF.

3.2. *Lack of risk aversion*

3.2.1. LEI

Even if individuals are well-informed about the risks and the potential benefits of insurance, there may simply be no demand because of lacking risk aversion. One can easily predict that the extent to which individuals are averse towards the risk of litigation depends on the costs involved (the legal fees to be paid) and the income situation of the citizen. The demand for LEI will be higher in a country where the average costs of a lawyer are relatively high. Also, demand should be higher for lower income individuals than higher income individuals. However, the paradoxical situation is that it may also be the lower income individuals who are less aware of the risks (and costs) involved with a trial and who for that reason have a smaller demand for LEI.

⁹⁰ On the costs of civil litigation in Europe, see Christopher Hodges, Stefan Vogenauer, Magdalena Tulibacka (eds), *The Costs and Funding of Civil Litigation: A Comparative Perspective*, Hart Publishing 2010.

Even within one country and within one category of disputes, the costs of lawsuits may vary significantly. They can range from very small (e.g. the defendant immediately acknowledges his fault and offers a reasonable settlement amount, which the plaintiff accepts) over medium to very large (e.g. personal injury cases which require several expert opinions). It is generally recognized that people are risk averse over large stakes.⁹¹ Thus for high-cost cases, a lack of risk aversion should not be expected. Note however that the case of disaster insurance shows that risk aversion may not always perfectly explain the demand for insurance. Given the potentially large impact of disasters one would expect a large insurance demand. However this is not the case. Often behaviour is observed whereby contrary to the expected utility theory insurance is not demanded even though there would be risk aversion.⁹² To the contrary sometimes insurance is observed even when risk aversion may be lacking. That is why alternative theories have been provided in explaining attitudes towards risk such as the prospect theory⁹³ and the transaction cost theory.⁹⁴

Regarding moderate-cost cases, there is some doubt in the insurance literature that people display substantial risk aversion. Some have argued that the premise of widespread risk aversion over small stakes is unrealistic.⁹⁵ However, many *laboratory experiments* using small stakes have

⁹¹ See for example Shavell, Steven, *Foundations of Economic Analysis of Law*, 2004, Cambridge, Massachusetts: Harvard University Press, p. 258: "Risk aversion is most relevant in situations in which losses would be large in relation to a person's assets and thus would impinge substantially on his utility. Individuals are typically viewed as risk-averse actors in relation to serious accidents, as these would be likely to cause losses that are significant in relation to their assets."

⁹² See Paul. J.H. Schoemaker & Howard Kunreuther, *An experimental study of insurance decisions*, 46J. RISK & INS. 603 (1979). Paul Slovic et al, *Preference for insuring against probably small losses: Insurance implications*, 44J RISK & INS. 237 (1977), Collin, F. Cammerer & Howard Kunreuther, *Decision processes for low probability events: Policy implications*, 8J POL'Y ANALISYS & MGMT, 565 (1989).

⁹³ Kahneman, D. & A. Tversky (1979), *Prospect theory: An analysis of decision under risk*, *Econometrica* 47, 263-291.

⁹⁴ See Skoch, G., *The transaction cost theory of insurance: Contracting impairments and costs*, *JOURNAL OF RISK AND UNCERTAINTY*, 417 (1989)).

⁹⁵ See e.g. Watt, Richard, "Defending Expected Utility Theory," *Journal of Economic Perspectives*, Vol. 16, pp. 227-229, 2002; Lucas, Robert, "Macroeconomic Priorities," *American Economic Review*, 93(1): 1-14, 2003; Palacios-Huerta, Ignacio, Robert Serrano, and Oscar Volij, "Rejecting Small Gambles Under Expected Utility," *Economic Letters*, 91(2): 250-259, 2006.

documented risk aversion.⁹⁶ The evidence of modest-stakes risk aversion in *market settings* is mixed however. For example, Cohen and Einav (2007) analyze deductible choice among Israeli auto-insurance customers.⁹⁷ More than 4 out of 5 drivers chose the highest deductible possible. On the contrary, Sydnor (2005) provides some micro-level evidence that the majority of people exhibit a relatively large degree of risk aversion over moderate financial stakes in a market setting.⁹⁸ He analyzes deductible choice among US home-insurance companies. A prototypical homeowner paid \$100 to reduce the deductible from \$500 to \$100. Given a claim rate less than 5 percent, the additional coverage was worth less than \$25 in expectation. The author argues that alternative explanations, like the overestimation of the likelihood of a loss or low wealth, are not very plausible. Note further that risk aversion is just one of the several theoretical reasons why individuals may take legal expenses insurance. Other reasons include: to strengthen ones bargaining position⁹⁹ and to be able to bring claims with negative expected value (even though they are strong claims). In conclusion, the lack of risk aversion can at best only be a partial explanation for the low frequency of LEI policies.

3.2.2. TPF

It's highly unlikely that a lack of risk aversion could hinder the market for TPF. First, TPF is often used for reasons that are not necessarily related to risk aversion: lack of funds (consumer funding), to remain solvent, alleviate cash-flow problems, compete for business and invest more in pending cases (funding of law firms), and to use less of ones own capital, to obtain an additional assessment of the merits of the case and to strengthen ones bargaining position

⁹⁶ E.g. Binswanger, H.P., "Attitudes Toward Risk: Theoretical Implications of an Experiment in Rural India," *The Economic Journal*, Vol. 91:364, pp. 867-890, 1981; Schechter, Laura, "Risk Aversion and Expected-Utility Theory: A Calibration Exercise," *Journal of Risk and Uncertainty*, 35(1): 67-76, 2007.

⁹⁷ Cohen, Alma and Liran Einav, "Estimating Risk Preferences from Deductible Choice," *American Economic Review*, 97(3): 745-788, 2007.

⁹⁸ Justin Sydnor "Sweating the Small Stuff: The Demand for Low Deductibles in Homeowners Insurance" University of California, Berkeley 2005.

⁹⁹ See Kirstein, Roland (2000), 'Risk Neutrality and Strategic Insurance', 25 *The Geneva Papers on Risk and Insurance*, 251-61.

(investment in commercial claims).¹⁰⁰ Second, in the context of litigation concerning large amounts, there is no lack of risk aversion.

3.3. *The existence of alternatives for access to justice*

3.3.1 LEI

A third potential explanation relates to the alternatives on which citizens may rely to deal with the risks of potentially getting involved in a dispute. In some legal systems risk averse individuals may use a result based compensation system to pay their lawyers. In the United States for example, the great majority of individual plaintiff's attorneys bring cases on contingency fee basis in tort litigation.¹⁰¹ In 1995, England instituted a variant of a contingent fee system, the conditional fee arrangement. Under this arrangement, the attorney pays all the plaintiff's costs if the case is lost, but receives her hourly wages plus a mark up if the case is won (or if there is a settlement).¹⁰² It can be predicted that demand for LEI may be lower in legal systems where individuals have the possibility of reducing the risks of a trial via result based compensation systems.

Additionally, we should expect demand for LEI to be lower if victims *ex ante* know that the state will cover (part of) their trial costs. Demand for LEI may especially be lower in systems with a general coverage of legal aid. One could also predict that when a state reduces the financing of its legal aid scheme, the demand for LEI will increase in that state. There is a simple economic logic behind this: if potential victims can rely on state aid that would (hypothetically) provide the same quality as services provided via LEI, relying on publicly provided legal aid is the cheapest option. No premium needs to be paid. In that sense, state provided legal aid creates a moral hazard

¹⁰⁰ See section 2.2.

¹⁰¹ A US survey by Kakalik and Pace (1986) showed that 96 percent of individual plaintiff's attorneys in tort litigation brought cases on contingency fee basis, while 95 percent of defendants' attorneys worked for an hourly wage. See Kakalik, J. and N. Pace. 1986. *Costs and Compensation Paid in Tort Litigation*. Santa Monica, CA: RAND Institute for Civil Justice.

¹⁰² See Rubinfeld, D. and Scotchmer, S. 1998. Contingent fees. In Newman, P (ed.), *The New Palgrave Dictionary of Economics and the Law*, London: MacMillan, p. 416.

problem whereby victims can free ride on the state. A similar argument has been made with respect to disaster insurance.¹⁰³ Some scholars claim that the low demand for this type of insurance is related to the *ex post* relief consisting of generous compensation by the state after an accident.¹⁰⁴ Potential victims would not be willing to pay a premium if they could free ride on the state.¹⁰⁵ There is also empirical evidence that shows that in legal systems which have a guaranteed compensation by the State (e.g. via a disaster fund, like in Austria) the demand for disaster insurance is lower than in countries where such *ex post* government relief is not provided (like in Germany).¹⁰⁶

Many of these theoretical findings are supported by empirical research. For example, a recent study from the Netherlands states that the growth of LEI between 1970 and 2009 runs parallel with the regular cuts in the legal aid system and with increases in private contributions over that period.¹⁰⁷ Note however that it's hard to persist that the availability of public legal aid or result based compensation systems fully explains the low frequency of LEI in some countries. Even though contingency fees may be useful in many instances, they offer no help to people who have only suffered relatively small losses and to plaintiffs in disputes that do not involve monetary stakes. In England and Wales not all cases can be financed under a CFA and for those cases the citizen may have a demand for LEI.¹⁰⁸ Also, there are countries where legal costs are too high for

¹⁰³ Compare Kaplow, L., "Incentives and Government Relief for Risk", *Journal of Risk and Uncertainty*, 1991, vol. 4, 167-175.

¹⁰⁴ In the literature this is referred to as the "Charity Hazard". See Raschky, P. and Weck-Hannemann, H., "Charity Hazard – A Real Hazard to Natural Disaster Insurance?", *Environmental Hazard*, 2007, vol. 7 (4), 321-329. See also S. Coate, "Altruism, the Samaritan's dilemma and government transfer policy", 85 (1) *AMERICAN ECONOMIC REVIEW* 46 (1995).

¹⁰⁵ See Epstein, R., "Catastrophic Responses to Catastrophic Risks", *Journal of Risk and Uncertainty*, 1996, vol. 12, 305.

¹⁰⁶ See Paul Raschky, Raimund Schwarze, Manjie Schwind and Hannelore Weck-Hannemann, *Alternative financing and insurance solutions for natural hazards. A comparison of different risk transfer systems in three countries – Germany, Austria and Switzerland – affected by the August 2005 floods*, Alps Centre for Natural Hazard and Risk Management, Innsbruck 2009.

¹⁰⁷ Ben van Velthoven en C. Klein Haarhuis, *WODC Geschillenbeslechtingdelta 2009*, Den Haag, Boom Juridische Uitgevers, 2009.

¹⁰⁸ See Faure, M.G., Fernhout, F.J. and Philipsen, N.J., *Resultaatgerelateerde Beloningssystemen voor Advocaten*, WODC, Dutch Ministry of Safety and Justice, via <http://wodc.nl/onderzoeksdatabase/internationale-vergelijking-beloningssystemen-advocatuur.aspx>, p. 59.

the majority of the population, where only a modest fraction of the population is eligible for free legal aid and where no *cure no pay* and *quota pars litis* are prohibited, but where LEI still is not so widespread. In 2003, for about 75% of the Belgian population the costs of a legal procedure were alleged to be too high (10% could finance it themselves without any problem and 15 % through legal aid).¹⁰⁹ Given the prohibition of output based remuneration systems and low amounts of public legal aid one would expect a strong demand for LEI in Belgium, which is apparently not the case.

3.3.2. TPF

Obviously there are parallels between the demand for LEI and the demand for TPF. Like in the case of LEI, the demand for TPF will to a large extent be explained by the availability of alternatives: in jurisdictions where publicly provided legal aid tends to be very generous (and hence the moral hazard problem or the “charity hazard” may arise), one can expect the demand for TPF to be relatively small. Individuals confronted with a lawsuit will have no demand for TPF if they can free ride on state provided legal aid. To the contrary one can expect the demand for TPF to increase where alternative funding systems are not available (or not adequate). Note that if a country allows contingency fees, this does not mean that TPF has no future there. There are several limitations on contingency fees.¹¹⁰ First, contingency fees help plaintiffs to transfer some litigation risk to their lawyers. But there are high investment cases that plaintiff’s lawyers are not eager to take. TPF funding may help risk-averse lawyers to take these cases. Also, lawyers are not allowed to pay cash for a fraction of their clients’ claims. They can only advance out-of-pocket litigation expenses under contingency fees. Third, contingency fee lawyers can

¹⁰⁹ Report of the working group “Rechten van Slachtoffers”(Rights of Victims), Parliamentary proceedings of the Belgian senate 2002-2003, 13 March 2003, 2-1275/1, p. 23 (also discussed in ¹⁰⁹ See Faure, M.G., Fernhout, F.J. and Philipsen, N.J., Resultaatgerelateerde Beloningssystemen voor Advocaten, WODC, Dutch Ministry of Safety and Justice, via <http://wodc.nl/onderzoeksdatabse/internationale-vergelijking-beloningssystemen-advocatuur.aspx>, p. 41).

¹¹⁰ See also David Abrams & Daniel L. Chen, A Market for Justice: The Effect of Litigation Funding on Legal Outcomes (2011), available at <http://www.duke.edu/~dlc28/papers/MktJustice.pdf>.

only pay with their services. The fraction of a claim that a lawyer can purchase is thus limited.¹¹¹ Summarizing, when lawyers are the only provider of capital, the amount and timing of the capital that may be provided is quite limited. Competition for capital-constrained clients is reduced, and this will result in higher costs for these clients. As Abrams and Chen (2011) put it: “By opening up provision of capital to the market, third party litigation funding solves a number of shortcomings whereas contingency fees do not.”¹¹²

Another question is to what extent the existence of LEI could hinder the development of TPF? As we have seen above, in some countries a large fraction of the population is covered by LEI (generally after government intervention). In other countries LEI is becoming more popular and several countries are thinking of ways to promote LEI to a broader public (such as the UK). If LEI is widespread, this will surely substantially diminish the demand in the segment of consumer legal funding. In the other segments however, LEI is no competition for TPF. For reasons of moral hazard and adverse selection, legal expenses insurance often provide relatively low upper limits on the maximum amount of coverage. Moreover, TPF is not so much an instrument to promote access to justice, but rather a financing and funding instrument. Hence, even under a contingency fee arrangement (which stimulates access to justice) for particular plaintiffs TPF may still be an attractive instrument to obtain upfront funding.

3.4. *Low probability of a pay-out*

3.4.1. LEI

Apart from the underestimation of risk phenomenon, another reason of a behavioral nature has been advanced in the literature to explain a low insurance demand. In the domain of disaster insurance, psychological experiments show that people may *ex ante* prefer uncertain losses rather

¹¹¹ Usually between 1/3 and 1/2 of the plaintiff’s recoveries.

¹¹² David Abrams & Daniel L. Chen, A Market for Justice: The Effect of Litigation Funding on Legal Outcomes (2011), available at <http://www.duke.edu/~dlc28/papers/MktJustice.pdf>.

than the certain loss of paying the premium. As the explanation goes, insurance is seen as an investment. People prefer to insure against high probability, low damage events since a monetary return on the investment is more likely.¹¹³ The problem, according to this literature, is that *ex ante*, the potential victim (like a house owner) is confronted with the certain loss of a premium, whereas the expected damage constitutes an uncertain loss (e.g. the case of a flooding). Given the uncertainty of the catastrophe there is a low expectation of a return on the “investment” during a lifetime and hence a low demand for catastrophe insurance.¹¹⁴ Experiments show that people prefer to insure against high probability-low loss events because in that case at least some return on the investment can be guaranteed. In the experiments, disaster insurance was sold along with insurance against more likely losses at reasonable extra costs (a so-called compound insurance). Twice as many people were willing to buy the compound insurance than the single policy against disasters.¹¹⁵

While this phenomenon may explain the low demand for disaster insurance, it is unlikely to be very relevant in the case of LEI. The simple reason is that disasters are typically low probability-high consequence events, but this is not the case for lawsuits. As mentioned above (see 3.1.1), empirical studies point out that a large fraction of people encounters legal problems on a regular basis. In other words, the expectation of a return on the “investment” should not be very small.

3.4.2. TPF

Whereas *ex ante* one could even doubt whether getting involved in a lawsuit should be considered as a low probability, high damage event, this is certainly not the case *ex post* where

¹¹³ See Slovic, P., Fischhoff, B., Liechtenstein, S., Corrigan, B. and Combs, B., “Preference for Insuring against Probable Small Losses: Insurance Implications” in Slovic, P. (ed.), *The Perception of Risk*, London, Earth scan Publications, 2000, 51-72.

¹¹⁴ Howard Kunreuther et al., A behavioural model of the adoption of protective activities, 6 *J. ECON. BEHAV. & ORG.* 1, 4 (1985).

¹¹⁵ See Slovic, P., Fischhoff, B., Liechtenstein, S., Corrigan, B. and Combs, B., “Preference for Insuring against Probable Small Losses: Insurance Implications” in Slovic, P. (ed.), *The Perception of Risk*, London, Earth scan Publications, 2000, 60,61.

the uncertainty is reduced to estimating the outcome of the case and the costs involved. There is hence, in the case of TPF, no risk of a low probability of a pay-out, which would lead to a lower demand. Moreover, TPF as a financing mechanism may be attractive for particular (individual or commercial) individuals who precisely receive direct funding in the TPF system.

3.5. Insurer ambiguity

3.5.1. LEI

Another traditional reason advanced in economic theory for failing insurance markets is not so much related to problems on the demand side, but rather to a problem on the supply side. Insurers need actuarial information both on the probability that the insured event will occur and on the potential damage. This will allow insurers to calculate actuarially fair premiums. The absence of historical data and imperfect knowledge on risks may lead to a lack of sufficient information for insurers to make an adequate assessment of risks.¹¹⁶ The lack of predictability regarding both the probability of an event occurring and of the outcome of such an event results in the phenomenon referred to as insurer ambiguity.¹¹⁷ This ambiguity may lead to uninsurability of specific risks, like in the case of catastrophes.¹¹⁸ Insurers can however take account of this uncertainty regarding the probability and the damage by charging a so-called risk premium.¹¹⁹ Nevertheless, two problems may still remain: (1) a higher insurance premium can decrease the demand for insurance, and (2) insurance regulation may limit an insurer's ability to apply high premiums in

¹¹⁶ See Faure, M.G. & Hartlief, T., *Insurance and Expanding Systemic Risks*, Paris, OECD, 2003, 260 p, at 84,85.

¹¹⁷ See Kunreuther, H., Hogarth, R. and Meszaros, J., "Insurer Ambiguity and Market Failure", *Journal of Risk and Uncertainty*, 1993, 71-87.

¹¹⁸ See Lewis Kaplow & Steven Shavell, *Fairness versus welfare*, 114 *HARVARD LAW REVIEW* 961 (2002).

¹¹⁹ Howard Kunreuther et al. *Ambiguity and underwriter decision processes*, 26J. *ECON. BEHAVE. & ORG.* 337, 338 (1995).

practice. If insurers were systematically more ambiguity – averse than consumers, insurability problems could be that large that a market does not emerge.¹²⁰

Again, this phenomenon of insurer ambiguity may to some extent explain difficulties in supplying catastrophe insurance but does not seem plausible in the case of LEI. After all, there is good data available on the likelihood that particular individuals get involved in a lawsuit and on the costs of the involvement of lawyers. Hence, in this domain insurer ambiguity should not necessarily be a huge problem.

3.5.2. TPF

Turning to TPF, one may wonder whether uncertainty in pricing litigation risk could be a major obstacle to its development. The assessment of litigation risk depends on quite a few uncertain variables: the facts, the current law, the jury pool, the presiding judge, the skills and incentive structure of the opposing counsel, risk aversion of the opposing party and more generally his incentives to settle.¹²¹ But clearly, the way lawyers price claims is not as sophisticated as the methods used in different financial risk models. The problem of ambiguity may not be too serious under TPF to the extent that TPF suppliers can specialize and as a result make easy and low cost assessments of the quality of a claim. A detailed analysis of the merits of a claim would lead to high administrative costs, but as a result of specialization TPF agencies may be able to quickly assess the merits relatively accurately, thus reducing administrative costs. Hence, ambiguity should not be a major problem under TPF.

3.6. *Adverse selection*

¹²⁰ Christian Gollier, Some aspects of the economics of catastrophe risk insurance, in: CATASTROPHIC RISK AND INSURANCE 13, 24 (2005).

¹²¹ See Jonathan Molot, Pooling Litigation Risk, working paper, via <http://www.law.harvard.edu/faculty/workshops/open/papers0708/molot.paper.pdf>.

3.6.1. LEI

The problem of adverse selection may play a role in the case of LEI to the extent that some individuals may be more likely to bring a legal claim than other individuals. If the insurer can not distinguish between individuals with a high propensity and those with a low propensity to get involved in a lawsuit, he will have to charge an average premium to all of them. Consequently, legal expenses insurance may be particularly attractive for high risk individuals.¹²² As a result, the ones taking out LEI will be more likely to be litigious, causing an increase in the premiums for LEI. This can go on until only the most litigious individuals remain interested in taking out LEI. Ultimately, this could lead to the uninsurability of particular risks.¹²³ Note that we may expect adverse selection problems to be more substantial for stand-alone LEI products than for add-on legal expenses insurance since for the latter LEI policies are added to other types of insurance, which usually have a well-balanced risk pool.¹²⁴ ¹²⁵ Note however that even the market for these add-on policies is thin in many countries.

However, the theoretical insurance literature has indicated that problems of adverse selection can be mitigated in several ways: the exclusion of certain risks from insurance¹²⁶, risk-based

¹²² See the seminal paper by George Akerlof, The market for 'lemons': Quality, uncertainty and the market mechanism, *QUARTERLY JOURNAL OF ECONOMICS* 488 (1970) and George Priest, The current insurance crises and modern tort law, *YALE LAW JOURNAL* 1521 (1987).

¹²³ *Ibidem*.

¹²⁴ See for example Kilian, Matthias & Regan, Francis (2004). Legal expenses insurance and legal aid - two sides of the same coin? The experience from Germany & Sweden. *International Journal of the Legal Profession*, vol. 11, pp. 233-255.

¹²⁵ Barzel (1982) shows that insurance packages that tying substitutes and excluding complements have desirable effects on moral hazard and adverse selection. With that kind of packaging, the extent of excess use will decline. Also, that type of insurance will be chosen by fewer people who impose larger costs than their valuation and by more people whose valuations exceed their costs. See Barzel, Yoram. 1982. Competitive Tying Arrangements: The Case of Medical Insurance. *Economic Inquiry*, 598-611.

¹²⁶ See Kilian, M., "Alternatives to Public Provision: The Role of Legal Expenses Insurance in Broadening Access to Justice: The German Experience", *Journal of Law and Society*, 2003, Vol. 30, p. 31-48, at 39.

diversification of premiums,¹²⁷ ceilings on the amount of coverage per period and offering a variety of insurance policies with different combinations of coverage and premia¹²⁸. Also, recent empirical research shows that adverse selection may be very dependent upon the type of insurance market and may in fact in many insurance markets not be as serious a problem as was supposed in the literature.¹²⁹

Recent empirical research from the Netherlands indicates that there seems to be no serious problem of adverse selection in the market for legal expenses insurance.¹³⁰ This research makes use of data gathered by a “Paths to Justice” survey, conducted in 2009. The survey investigated the extent to which individuals in the Netherlands were faced with justiciable problems in the fields of civil and administrative law from the 1st of January 2004 to the 31st of December 2008. They were given a list of 67 different types of problems, followed by a few “catch-all” questions. The sample (2.940 persons) is representative for the Dutch population in terms of age, education and sex. Respondents were asked if they were covered by any kind of LEI policy (and if so, which modules were covered). Turning to the results, 60.5 percent of the respondents faced one or more (non-trivial¹³¹) justiciable problem. The average number of problems for the total group of respondents was 1.88. The problem frequency of individuals with LEI was 11 % higher than for individuals without LEI (1.97 versus 1.78). The researchers recognize that this difference can be explained by two effects, a selection effect and a behavioral effect (moral hazard, see also 3.7). When controlling for several personal characteristics (like age, marital status, education and

¹²⁷ Whenever possible, insurers should differentiate between high and low risk individuals. If high risk individuals (say, those who are very litigious) can be charged higher premiums, the unravelling of risk pools (typical for adverse selection) can be prevented.

¹²⁸ This may induce policyholders to reveal their type. See Emons, Winand (1989), ‘The Theory of Warranty Contracts’, 3 *Journal of Economic Surveys*, 43-57, at 50-52 (in the context of warranty contracts).

¹²⁹ See Willem van Boom, “Insurance Law and Economics: an Empirical Perspective”, in Faure, M. and Stephen, F. (eds), *Essays in the Law and Economics of Regulation*, in Honour of Anthony Ogus, Intersentia, Antwerp, 2008, 256-259.

¹³⁰ See Klein Haarhuis, Carolien, en Ben van Velthoven, *Legal Aid and Legal Expenses Insurance, Complements or Substitutes? The Case of the Netherlands*, Leiden Law School, Department of Economics Research Memorandum 2010.02, available at <http://media.leidenuniv.nl/legacy/bvv-2010-02.pdf>.

¹³¹ The researchers considered a problem as trivial if the respondent had not taken any action either because the problem was not important enough, or because the respondent did not dispute the outcome, or because the respondent believed that the other side was right.

social group), the researchers find that LEI holdership increases the frequency of justiciable problems by 8%. In other words, there is a selection effect of 3 % and a behavioral effect of 8 %. In sum, it's unlikely that problems of adverse selection can explain the relatively small size of LEI markets.

3.6.2. TPF

Adverse selection may also plague TPF markets. The exact nature and extent of this problem may depend on the TPF segment involved. In the segment of consumer legal funding, those consumers who think that they are more likely to obtain no recovery or a recovery not much in excess of their non-recourse loan, envisage lower costs to promising to pay out of their proceeds. The fact that individual transactions are fairly small in this segment means of course that TPF suppliers will not be willing to spend a lot on evaluating prospects for repayment ("due diligence costs"). All of this is related to the general issue that adverse selection basically arises because of information asymmetry between the individual covered by TPF and the funding agent. The individual may have better information on the quality of his case but may not be willing to reveal this to the financing agent (in order to get a better deal on the TPF). For small risks, TPF agents will, just like insurers, classify risks and try to remedy adverse selection through risk classification, an individual risk assessment being too costly. However, there's also a positive side. Given the relatively small amount of funding per transaction in the segment of consumer loans, well-capitalized suppliers can have many loans outstanding concurrently, and portfolio risk can be very small (at least if the cases are sufficiently unrelated). The fact that contingency fees are prohibited in many European countries, could make it more difficult for this segment to develop in Europe (at least when focusing on adverse selection problems). When a lawyer has accepted a case on a contingency-fee basis, funders may view this as a positive signal about the merits of the case. This could be especially helpful if TPF suppliers have information about how well the relevant lawyers screen cases. Empirical research by Helland and Tabarrok (2003)¹³² find

¹³² Helland, Eric and Alexander Tabarrok (2003), "Contingency Fees, Settlement Delay and Low-Quality Litigation: Empirical Evidence from Two Datasets," *Journal of Law, Economics, and Organization*, 19: 2. The authors use a cross-section of states and a time series of medical malpractice claims in Florida.

that legal systems supporting contingency fees increase legal quality and decrease the time to settlement. This is consistent with a theoretical model of Dana and Spier (1993).¹³³ These authors showed that contingency fees decrease frivolous lawsuits. Fenn and Rickman (2010) summarize empirical studies of contingency fee arrangements and state that lawyers who use no win no fee arrangements do more screening and settle their cases sooner.¹³⁴ Of course, this screening is far from perfect. Contingency fee lawyers may still bring weak cases, as long as the expected benefit outweighs the cost. This will especially be the case for large stakes claims. With respect to the segment of loans to plaintiffs' law firms, firms nearer to financial collapse are more likely to ask for a loan because they simply have little to lose. TPF suppliers may be willing to spend more on evaluating the prospects for repayment than in the segment of consumer legal funding, since the average size of the loan is larger. Finally, in the segment of investments in commercial litigation, owners of commercial claims are more likely to be willing to share the financial upside of their claims when they are less optimistic about the probability of winning the claim and the likely damages. However, in commercial litigation, TPF suppliers may well be willing to invest more to evaluate the quality of the claim, given the larger amounts at stake.

3.7. Moral hazard

3.7.1. LEI

In the presence of asymmetric information, LEI markets may also suffer from moral hazard problems.¹³⁵ Moral hazard is the tendency of individuals to exercise less care in protecting themselves against loss if they are fully insured against it. It's a form of ex post opportunism which occurs when the insurer cannot observe the actions of the insured. In such a case, the

¹³³ Dana, James D. and Kathryn E. Spier (1993), "Expertise and Contingency Fees: The Role of Asymmetric Information in Attorney Compensation." *Journal of Law, Economics and Organization*. 9(2): 349-367.

¹³⁴ Fenn, P.; Rickman, N. (2010)., "The Empirical Analysis of Litigation Funding", in Tuil, M and Visscher L (ed) *New Trends in Financing Civil Litigation in Europe*, Edward Elgar Publishing Limited.

¹³⁵ On moral hazard and insurance, see Shavell, S., "On Moral Hazard and Insurance", *Quarterly Journal of Economics*, 1979, 541-562.

insurer is unable to link premiums to the actions of the insured. The insured will reduce his level of care, and this increases insurance premiums. The increase may be so large that the individuals facing the risk prefer to remain uninsured and instead increase their private level of care. This can cause a breakdown of the insurance market.

In the context of LEI, we can distinguish between several variants of moral hazard. First of all, people who know that they can rely on legal assistance in a legal dispute, may be less hesitant to enter into situations that have the potential to generate legal problems. For example, such a person may have a weaker incentive to screen future contract parties for their reputation of being a defaulter. Individuals with LEI may also be more likely to bring existing problems to a head.¹³⁶ Next, an insured person may be less hesitant to start a legal action than an uninsured person, even when the claim is rather weak.¹³⁷ Also, a policyholder may want to pursue a claim much more intensely than a person without legal expenses insurance.¹³⁸ He may want his insurer (or lawyer) to spend much more time on the case than is warranted by the economic fundamentals of the case. Finally, the insurer may face a moral hazard problem not only in his relationship with the insured, but also with the insured's lawyer. Given the deep pockets of the insurance company, a lawyer may feel less restricted to behave opportunistically.

Also for moral hazard problems there are, as we indicated above, several standard responses that can also be helpful in the context of legal expenses insurance.¹³⁹ As far as the insured is concerned, mechanisms can be introduced in the insurance policy allowing the insurer some control on whether or not to file a lawsuit or limiting the free choice of an attorney (if allowed by

¹³⁶ See Klein Haarhuis, Carolien, en Ben van Velthoven, *Legal Aid and Legal Expenses Insurance, Complements or Substitutes? The Case of the Netherlands*, Leiden Law School, Department of Economics Research Memorandum 2010.02, available at <http://media.leidenuniv.nl/legacy/bvv-2010-02.pdf>, p. 7.

¹³⁷ Van Velthoven and Ter Voert, 2003, 151. B. van Velthoven and M. ter Voert, *Geschilbeslechtingdelta 2003*, Boom, Den Haag, 2003.

¹³⁸ R. Bowles and N. Rickman, 'Asymmetric Information, Moral Hazard and the Insurance of Legal Expenses', 23 *Geneva Papers on Risk and Insurance*, 1998, 196-209, at 197.

¹³⁹ For a summary of the literature on Moral Hazard see van Boom, W., "Insurance Law and Economics: An Empirical Perspective" in Faure, M. and Stephen, F. (eds.), *Essays in the Law and Economics of Regulation*. In Honour of Anthony Ogus, Antwerp, Intersentia, 2008, 253-276.

law).¹⁴⁰ In the latter case the advantage for the insurer is that a more limited choice to the insured can be provided between several attorneys with whom the insurer can make *ex ante* agreements related to fees. Also, the insurer can design contractual limitations that have the effect of risk sharing between insurer and insured (deductibles, minimum claim levels, co-insurance etc.).¹⁴¹ The insured then has an incentive to limit legal costs (at least to a certain extent). Moral hazard on the side of the attorney is obviously larger in legal systems where hourly fees can be charged and fees are unregulated.¹⁴² Hence it can be predicted that if legal systems have a regulation of attorneys fees this could increase the *ex ante* possibilities of adequate risk calculation for the insurer. Thus one could predict LEI to be more frequent in legal systems where attorney fees are regulated or other mechanisms exist for the insurer to control for moral hazard of insured and attorneys (see section 2.1.3 for the case of Germany). This may well explain the success of LEI in Denmark: since attorney fees are under LEI in Denmark in principle limited to the amount they would receive under legal aid moral hazard can be effectively controlled.

Empirical research from the Netherlands shows that the moral hazard problem is relatively small in the context of LEI.¹⁴³ LEI holdership increases problem frequency by 8 % (see also at 3.6.1). German research shows that legal expenses insurance does not automatically lead to a litigation explosion. Insured plaintiffs litigate only 5 to 10 percent more often than uninsured plaintiffs.¹⁴⁴ In some fields of litigation, the differences are smaller. Only in the contestation of traffic misdemeanors, larger differences have been observed (10 to 27 percent). It seems hence unlikely that moral hazard can explain low LEI frequencies.

¹⁴⁰ As we already mentioned above EC directive 87/344 of 22 June 1987 seriously limits the possibility to restrict the insured's right to choose his own lawyer. This can only be stipulated if specific conditions are fulfilled.

¹⁴¹ See Kilian (2003), at 39.

¹⁴² See for a summary of the literature Stephen, F.H. and Love, J.H., "Regulation of the Legal Profession" in Bouckaert, B. and De Geest, J. (eds.), *Encyclopedia of Law and Economics*, Cheltenham, Edward Elgar, 2000, 987-1017.

¹⁴³ See Klein Haarhuis, Carolien, en Ben van Velthoven, *Legal Aid and Legal Expenses Insurance, Complements or Substitutes? The Case of the Netherlands*, Leiden Law School, Department of Economics Research Memorandum 2010.02, available at <http://media.leidenuniv.nl/legacy/bvv-2010-02.pdf>.

¹⁴⁴ See Blankenburg E, Fiedler J 1981 *Die Rechtsschutz.ersicherung und der steigende GeschaX ftsanfall der Gerichte (Legal Insurance and the Growing Demands on the Courts)*. Mohr, Tubingen; Jagodzinski W, Raiser T, Riehl J 1994 *Rechtsschutz.ersicherung und Rechts.erfolgung (Legal Insurance and the Recourse to the Court)*. Bundesanzeiger, Koln.

3.7.2. TPF

Moral hazard problems can also be present in the market for third-party financing. In the context of consumer legal funding, as soon as a consumer's prospect of having some money left after paying out the TPF supplier gets sufficiently small, the consumer has no incentive to pursue his claim. Of course, this will drive up the price of the non-recourse loans. But again, moral hazard may be problematic under TPF but is again not insurmountable. The TPF contract can e.g. contain clauses guaranteeing the consumer's cooperation even after the initial sum has been received. That may indeed be the main problem in each TPF segment: creating incentives for whoever makes the decisions (the TPF receiver or supplier) to take into account the costs and benefits of both entities, and not only its own costs and benefits. As long as the decisionmaker bears an equal share of the costs and benefits of each additional investment in the case, we can expect him to behave in an optimal way from the point of view of both entities (the TPF receiver and supplier). Under such a scheme, marginal costs equal marginal benefits for the decisionmaker at the same point where total marginal costs equal total marginal benefits.¹⁴⁵ However, such incentive schemes are not observed in the three different segments of TPF, so we should expect at least some moral hazard problems.

One may fear that TPF of mass consumer claims may worsen the incentive to file frivolous and weak class action suits. Even without TPF, some observers feel that the settlement leverage created by class certification pressures defendants to settle such suits.¹⁴⁶ The main reason is that class actions magnify stakes and complexity. This compounds the defendant's litigation, reputation and risk-bearing costs. Several reform proposals have been advanced: strengthening

¹⁴⁵ For such a scheme in the context of contingency fees, see A. Mitchell Polinsky & Daniel L. Rubinfeld, 2003. "Aligning the Interests of Lawyers and Clients," *American Law and Economics Review*, Oxford University Press, vol. 5(1), pages 165-188.

¹⁴⁶ Robert G. Bone & David S. Evans, *Class Certification and the Substantive Merits*, 51 *DUKE L.J.* 1251 (2002); George L. Priest, *Procedural Versus Substantive Controls of Mass Tort Class Actions*, 26 *J. LEGAL STUD.* 521 (1997).

sanctions for frivolous filings, shifting some portion of the winner's attorney's fee to the losing side¹⁴⁷, have the trial judge conduct a preliminary merits review at the certification stage¹⁴⁸ and have the judge hold multiple class trials and base its judgment on a weighted combination of the several verdicts.¹⁴⁹

3.8. Positive externalities/The free rider problem

3.8.1. LEI

Recently, another reason for a market failure in LEI has been advanced.¹⁵⁰ The difficulties of LEI could be attributed to free rider problems that result from positive externalities. Insurance generally does not create positive externalities. For example, if an insured piece of jewelry gets stolen, only the owner will benefit from the theft insurance. Legal expenses insurance may create positive externalities however. A potential victim who takes LEI may be able to bring a case to court which he would otherwise not have brought because of risk-aversion or lack of funds. When more individuals take LEI, the probability that an injurer will go scot-free decreases. A potential injurer takes this into account when deciding on his care level and takes additional care. The additional deterrence created by LEI driven litigation lowers the probability that *other* people will get injured. So individuals only internalize a small part of the deterrent effect of taking LEI, and they benefit from the decisions of others to take LEI. In theory, this can lead to a free rider problem. Obviously, this effect is only relevant in situations where the injurer cannot differentiate

¹⁴⁷ Deborah R. Hensler & Thomas D. Rowe, Jr., *Beyond "It Just Ain't Worth It": Alternative Strategies for Damage Class Action Reform*, 64 LAW & CONTEMP. PROBS. 137 (Spring/Summer 2001).

¹⁴⁸ Robert G. Bone & David S. Evans, *Class Certification and the Substantive Merits*, 51 DUKE L.J. 1251 (2002)

¹⁴⁹ Bruce L. Hay & David Rosenberg, "Sweetheart" and "Blackmail" Settlements in Class Actions: *Reality and Remedy*, 75 NOTRE DAME L. REV. 1377 (2000).

¹⁵⁰ See De Mot, Jef and Faure, Michael. 2011. Legal Expenses Insurance and the Free Rider Problem. Working paper.

between parties with and without an insurance policy (as is generally the case for torts).¹⁵¹ Furthermore, we can expect the free rider problem to be most prevalent in those cases in which first party damage insurance is available. If first party damage insurance is not available or only very partially, then potential victims will be more inclined to take LEI if they are sufficiently risk averse.

Even if potential victims would not have an incentive to free ride, there could be a free rider problem on the supply side when the deterrence benefits of LEI driven litigation are substantial. If an insurance company has a market share of, say, 10 percent in the LEI market, then 90 percent of the deterrence benefits of each LEI policy will go to other insurance companies. This could lead to a free rider problem which prevents the insurance industry from taking meaningful action.¹⁵² This could explain why there are so few companies that offer very comprehensive policies.¹⁵³ A similar argument has been made with respect to Lojack.¹⁵⁴ The question why most auto insurance companies give no discount for Lojack has been answered from two different perspectives.¹⁵⁵ According to one view, Lojack is not a winner for insurers with a relatively low market share, since most of the benefit will go to their rivals.¹⁵⁶ According to another view, Lojack is probably not very effective. If it were, the free rider problem could be easily solved. If car manufacturers like Porsche would install Lojack on their cars, thieves would stay away from

¹⁵¹ If the injurer can differentiate between parties before deciding on his level of care, insurance for legal expenses would not create positive externalities, at least if the injurer is able to adjust his level of care for each party individually.

¹⁵² Especially for NEV claims.

¹⁵³ For the UK, see FWD, 2007, The Market for 'BTE' Legal Expenses Insurance, <http://www.justice.gov.uk/publications/docs/market-bte-legal-expenses-insurance-a.pdf>, p. 52.

¹⁵⁴ With Lojack, a small radio transmitter is hidden in one of many possible locations within a car. When a car is reported stolen, the police activates the transmitter and specially equipped police cars and helicopters track the precise location and movement of the vehicle.

¹⁵⁵ In some states discounts are mandated.

¹⁵⁶ Ian Ayres and Barry Nalebuff, "Stop, Thief!", *Forbes*, January 10, 2005, http://www.forbes.com/forbes/2005/0110/088_print.html.

these cars, and these car manufacturers would reap the benefits.¹⁵⁷ Even if this argument is correct, it would be hard to find an analogous market solution in the context of LEI for torts.

3.8.2. TPF

In the previous section, we have seen that there can be a problem of positive externalities when potential victims decide whether to take LEI or not. In the context of TPF, individuals deciding whether to use TPF or not will also not take the positive externalities of their decisions into account. This is a straightforward application of the theory of Shavell (1982).¹⁵⁸ When a victim has suffered harm, he does not take the general deterrent effect of his lawsuit into account, since filing a lawsuit cannot change the behavior of the injurer anymore. The victim only looks at the damages he could be awarded. We have also seen in the previous section that the presence of positive externalities may lead legal expenses insurers not to offer comprehensive LEI. In the context of TPF however, we may face a different problem. If a TPF supplier provides a lot of funds for a specific type of claim, this may increase deterrence for these claims. Consequently, there will be less of these cases in the future, which reduces the future profits of the TPF industry in this segment. The company that provides funds for these claims only suffers part of the harm, the rest is externalized: the future profits of the other companies decrease as well. So *from the perspective of the TPF industry*, there may be too much TPF. Each company may only suffer a small future loss if TPF is currently provided on a generous basis and for claims that can (rather easily) be deterred, but the loss of profit for the entire industry could be substantial.

What if the TPF industry is not competitive or the various suppliers can make agreements about the funds they channel to various types of claims? Then funds may not go to the claims that

¹⁵⁷ When the rate of theft of a car model decreases, the car model becomes more attractive to consumers by lowering insurance premiums. See Lott, John R. 2007. *Freedomnomics. Why the Free Market Works and Other Half-Baked Theories Don't*. Washington, DC: Regnery Publishing, pp. 43-44.

¹⁵⁸ Shavell, Steven. 1982. The Social versus the Private Incentive to Bring Suit in a Costly Legal System. *Journal of Legal Studies* 11: 333-339.

deserve funding most from a social point of view: the cases that can be easily deterred. It's unlikely that the TPF industry has an interest in substantially decreasing the accident rate. The more accidents are deterred, the less need for TPF. A monopolistic TPF industry will provide funding until its marginal benefit equals its marginal cost. Such an industry will prefer to divert funds to cases that are difficult to deter, since this will not affect its future income stream. A parallel can be made here with the incentives of the insurance industry to reduce the accident rate. In the insurance literature, there is a striking diversity in point of view with respect to the insurance industry's interest in accident reduction.¹⁵⁹ According to one view, the insurance industry has a positive interest in accident reduction.¹⁶⁰ A second view states that the insurance industry is simply not interested in the objective of accident reduction.¹⁶¹ A third view holds that the interest of the insurance industry is in fact served if the accident rate is at a high level.¹⁶² ¹⁶³ This question has received relatively little attention in the law and economics literature. In the context of product liability litigation, Viscusi (1991) notes that "in the long run the insurance industry will profit from a high level of liability since that will increase the degree of coverage it

¹⁵⁹ See generally Wilde, Gerald J.S. 1994. *Target Risk*. Toronto, Canada: PDE Publications.

¹⁶⁰ As one commentator puts it: ". . . it is obviously of great interest for the insurance companies [...] to reduce the number of traffic accidents and consequently their cost." See Vaaje, T. (1991). Rewarding in insurance: Return of part of premium after a claim-free period. Proceedings, OECD/ECMT Symposium on enforcement and rewarding: Strategies and effects. Copenhagen DK, Sep. 19-21, 1990.

¹⁶¹ ". . . insurance. . . is essentially neutral and indifferent with regard to the occurrence of the events that society defines as accidents. . . Hence, one can rightfully ask if the very mention of 'preventive action by insurance' is not stupid, though well-intentioned". See Chich, Y. (1991). *L'assurance automobile peut-elle et veut-elle investir dans l'action préventive?* Proceedings, OECD/ECMT Symposium on enforcement and rewarding: Strategies and effects. Copenhagen, Sep. 19-21, 1990.

¹⁶² See Wilde, Gerald J.S. 1994. *Target Risk*. Toronto, Canada: PDE Publications . See also Gray, M. (1989). Insurance logic that is blind to safety inventions. *Lloyd's List*, No. 54340, Nov. 2, who notes "All it needs is the insurance industry to require such equipment to be mandatory, suggest these hopeful people--once again falling into the age-old trap of assuming that the purpose of insurance is in some way to increase safety, or alter human nature, or dramatically to affect statistics. It is an argument which apparently has right and justice on its side, until the truth dawns that insurers are not philanthropists or safety agencies, but merely takers of commercial risks--nothing more, nothing less. Consider the conflict of sentiment which would flash through an underwriter's mind if a wild-eyed inventor burst into his office, waving plans for some equipment that would make ships virtually unsinkable".

¹⁶³ Studies by Adams (1985) and Finsinger (1988) show that insurers have an interest in a high accident rate under some types of premium regulation (they have insufficient incentives to control moral hazard). See Adams, Maurice. 1985. *Ökonomische Analyse der Gefährdungs- und Verschuldenshaftung*. Heidelberg: R. v.Decker's Verlag; Finsinger, Jörg. 1988. *Verbraucherschutz auf Versicherungsmärkten. Wettbewerbsbeschränkungen, Staatliche Eingriffe und Ihre Folgen*. München: V. Florentz.

can write.”¹⁶⁴ Note that this problem may also arise in the context of LEI. Offering comprehensive LEI policies could reduce the accident rate as well for some types of claims. Whether this problem is substantial for LEI will depend on (1) the relationship between profit per insurance contract and types and frequency of accidents and (2) whether LEI insurers and liability insurers/damage insurers are integrated or not. Note that the additional premium income from LEI would partially offset the losses in premium income for other insurance policies.¹⁶⁵

4. Advantages and disadvantages of TPF and LEI

In the previous section we started from the finding that in many legal systems LEI only has a relatively low coverage although it would be attractive to risk averse individuals and we try to present reasons for this low coverage. Moreover, we analyzed whether the reasons for low coverage of LEI also play under TPF. Roughly the conclusion is that many of the problems that could arise under LEI do not, or at least not to the same extent, play a role under TPF. That could make TPF a promising vehicle to finance litigation. The literature has, however, indicated other elements of the civil litigation system which may be influenced by the financing structure, such as the volume (4.1), overall quality (4.2) of the litigation as well as the likelihood of settlements (4.3) and the costs of disputes generally (4.4)

4.1. The volume of litigation

4.1.1. TPF

¹⁶⁴ Viscusi, W. Kip. 1991. The Dimensions of the Product Liability Crisis. *Journal of Legal Studies* 20:147-177. Viscusi (2004) however explains that in markets in which there is substantial price inflexibility due to regulation, the insurance industry could have an incentive to support tort reform which reduces the potential market for insurance. See Viscusi, W. Kip. 2004. Tort Reform and Insurance Markets. *Risk Management and Insurance Review* 7: 9-24.

¹⁶⁵ How much of the losses would be offset may depend on many factors like insurance regulation (e.g. premium regulation), barriers to entry and more generally, the degree of competition between insurers.

According to some, an increase in the quantity of litigation due to the availability of TPF is a matter of simple economics.¹⁶⁶ For example, third party financing may increase the amount and cost of litigation for business disputes. Without TPF, a plaintiff-business will compare the internal cost of capital with the expected return from filing a lawsuit. Only if the expected return is large enough will the case be filed. If TPF is available at a lower expected cost than the internal cost of capital, then we may expect more litigation by business plaintiffs.¹⁶⁷ This cost reducing effect of TPF may also increase the amount of litigation by reducing the settlement surplus. Indeed, when the trial costs of either the plaintiff or the defendant decrease, the settlement surplus decreases.¹⁶⁸ Generally, this leads to more trials since one of the reasons parties settle is to avoid the costs of trial. TPF can also increase the volume of litigation involving individuals as plaintiffs. In the US, these plaintiffs can often rely on contingency fees to finance litigation. However, this does not mean that TPF will not increase litigation in this segment. There are positive expected value cases which individual attorneys or law firms are unwilling to accept on a contingency fee basis because of the large risk attached to them (e.g. large class actions).¹⁶⁹ Limits on economies of scale make litigation in many very large cases at the same time not feasible. Here, third party financing could fill a gap¹⁷⁰, because there are greater economies of scale in finance than in

¹⁶⁶ See e.g. Rubin, Paul. 2009. On the Efficiency of Increasing Litigation. Via <http://www.law.northwestern.edu/searlecenter/papers/Rubin-ThirdPartyFinancingLitigation.pdf>.

See also Beisner, John, Jessica Miller, and Gary Rubin, Selling Lawsuits, Buying Trouble—Third-Party Litigation Funding in the United States, Washington, D.C.: U.S. Chamber Institute for Legal Reform, 10th Annual Legal Reform Summit, Washington, D.C., October 28, 2009. As of April 23, 2010: <http://www.instituteforlegalreform.com/images/stories/documents/pdf/research/thirdparty litigation financing.pdf>.

¹⁶⁷ See also Rubin, Paul. 2009. On the Efficiency of Increasing Litigation. Via <http://www.law.northwestern.edu/searlecenter/papers/Rubin-ThirdPartyFinancingLitigation.pdf>.

¹⁶⁸ Note that for both parties the decision to settle or litigate depends on a comparison of the expected returns from litigating with the cost of capital.

¹⁶⁹ The risk can be so large that losing such a case would lead to bankruptcy of the law firm.

¹⁷⁰ See Abramowicz, Michael, "On the Alienability of Legal Claims," *The Yale Law Journal*, Vol. 114, No. 4 (Jan.), pp. 739, 2005.

litigation.¹⁷¹ A recent empirical study by Abrams and Chen¹⁷² found that the number of suits increased in Australia after it allowed the free sale of lawsuits.

Others are more hesitant to draw such a general conclusion.¹⁷³ First, the fact that more individuals or organizations are able to bring claims to court that they otherwise would not bring, or the fact that they can fight a claim more vigorously with TPF, increases deterrence of behavior that could lead to lawsuits. Consequently, the availability of funds to pursue litigation does not unambiguously increase litigation.¹⁷⁴ Second, the statistical analyses of Abrams and Chen rely on small sample sizes (5 to 7 observations). More empirical research is necessary. Third, the question whether TPF will substantially increase the volume of litigation may vary from country to country, depending on the current instruments available in that country to increase access to the courts. For example, the increase in litigation in the US could be modest, if lawsuits aren't currently filed not because of lack of capital, but because the lack of additional potential claims that contingency fee lawyers are willing to take.¹⁷⁵ In Europe however, the potential for TPF to increase litigation may be greater, given that in many European countries contingency fees are prohibited (and public legal aid is being reduced in some countries and legal expenses insurance is not generally widespread).

¹⁷¹ See Rubin, Paul. 2009. On the Efficiency of Increasing Litigation. Via <http://www.law.northwestern.edu/searlecenter/papers/Rubin-ThirdPartyFinancingLitigation.pdf>.

¹⁷² David Abrams & Daniel L. Chen, A Market for Justice: The Effect of Litigation Funding on Legal Outcomes (2011), available at <http://www.duke.edu/~dlc28/papers/MktJustice.pdf>.

¹⁷³ See e.g. See Steven Garber, Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns, RAND Institute for Civil Justice, OP-306-LFCMP, 2010, 66 pp., ISBN: 978-0-8330-4990-2.

¹⁷⁴ See also Dana, David, and Max Schanzenbach, "How Would Third Party Financing Change the Face of American Tort Litigation? The Role of Agency Costs in the Attorney-Client Relationship," paper presented at Searle Public Policy Roundtable on Third Party Financing of Litigation, Northwestern University Law School, Chicago, Ill., September 24–25, 2009, p. 9. Available through: http://www.law.northwestern.edu/searlecenter/papers/Schanzenbach_Agency%20Costs.pdf.

¹⁷⁵ Kritzer, Herbert M., "Contingency Fee Lawyers as Gatekeepers in the Civil Justice System," *Judicature*, Vol. 81, July–August 1997, pp. 22–29.

As Garber (2010) points out, the conditions for TPF to increase litigation may strongly depend on the TPF segment involved.¹⁷⁶ Regarding loans to plaintiffs' law firms, an increase in the volume of litigation is to be expected if law firms use the funds to take on more clients, and not to smooth cash flow or to work more on cases they have already taken¹⁷⁷. In the segment of investments in commercial claims, the number of claims may increase substantially if there are a significant number of companies that are not able or willing to use internal capital to pay hourly based legal expenses and cannot find a lawfirm to represent it on a contingency fee basis, while the economics of the claim look attractive to a TPF supplier. The strength of the effect in this segment is difficult to predict, given that there are many unknowns regarding these conditions. For example, it is unclear whether TPF suppliers have the capacity or willingness to make TPF available to companies that are truly capital-constrained. Also, we do not know whether the level of demand for contingency fee based legal services in commercial litigation exceeds supply or not. If it does, there could be a considerable demand for TPF in this segment.

4.1.2. LEI

On a theoretical level, legal expenses insurance may increase the volume of litigation for several reasons. First of all, a person with LEI may face more justiciable incidents as a result of moral hazard (see section 3.7.1). However, we have seen that empirical research from Germany and the Netherlands shows that the effect of moral hazard is relatively small. Second, given a justiciable problem, LEI lowers the threshold for undertaking legal action. Claims with negative expected value may now be pursued, because (part of) the costs are paid by the insurer.¹⁷⁸ Note however that not all costs are externalized to the insurer (e.g. psychological costs and the opportunity cost

¹⁷⁶ Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*, RAND Institute for Civil Justice, OP-306-LFCMP, 2010, 66 pp., ISBN: 978-0-8330-4990-2.

¹⁷⁷ Of course this will increase the costs of individual cases.

¹⁷⁸ See Kirstein, Roland (2000), 'Risk Neutrality and Strategic Insurance', 25 *The Geneva Papers on Risk and Insurance*, 251-61; Van Velthoven, Bart and Van Wijck, Peter (2001), 'Legal cost insurance and social welfare', 72 *Economics Letters*, 387-96.

of time). Also, most LEI policies include a deductible.¹⁷⁹ Third, LEI promotes the filing of suit by risk-averse plaintiffs, since they don't bear the full litigation cost risk. Fourth, with LEI, liquidity constrained plaintiffs may now bring suit where they otherwise would not have been able to do so. Recent empirical research from the Netherlands sheds some light on the question whether LEI holders react differently from non-insured individuals, given a justiciable problem.¹⁸⁰ Of all the individuals facing a justiciable problem but who do not have LEI, 7.5 % does nothing, 47.4 % set out to resolve the problem without help, and 45.1 % seeks advice from one or more experts or organizations. LEI holders seek more advice and are less inclined to resolve the problem without help: 4.8 % does nothing, 37.7 % set out to resolve the problem without help, and 57.5 % seeks advice from one or more experts or organizations. The difference between the insured and the non-insured specifically holds for the higher income classes. Finally, during settlement negotiations, an insured plaintiff may take a tougher stance against the defendant, since he doesn't bear (all) the costs of a trial. Since the settlement surplus decreases, we can expect the trial frequency to increase. However, this does not take into account the active role that legal expenses insurers may play in the settlement stage. In countries like Belgium, where lawyers enjoy monopoly rights for representation in court but not for out of court work, an insurer can reserve himself the right to take all necessary steps to settle the case.¹⁸¹ Since the insurer bears most or all of the costs, he may have a large incentive to settle the case. The fact that the settlement frequency of claims covered by LEI (80 percent) is perceived to be significantly larger than the settlement frequency of other claims, seems to confirm this.¹⁸² However, this result could also be the consequence of selection effects. According to the standard relative optimism model

¹⁷⁹ See e.g. Kilian, Matthias (2003), 'Alternatives to Public Provision: The Role of Legal Expenses Insurance in Broadening Access to Justice: The German Experience', 30 *Journal of Law and Society*, 31-48, at 45.

¹⁸⁰ See Klein Haarhuis, Carolien, en Ben van Velthoven, *Legal Aid and Legal Expenses Insurance, Complements or Substitutes? The Case of the Netherlands*, Leiden Law School, Department of Economics Research Memorandum 2010.02, available at <http://media.leidenuniv.nl/legacy/bvv-2010-02.pdf>.

¹⁸¹ See Colle, Philippe (2005), *Handboek bijzonder gereguleerde verzekeringscontracten*, Antwerpen, Intersentia, at 304.

¹⁸² See Colle, Philippe (2005), *Handboek bijzonder gereguleerde verzekeringscontracten*, Antwerpen, Intersentia, at 304.

of litigation, the settlement frequency is larger for smaller claims¹⁸³, and LEI can be expected to stimulate some of these smaller claims. Empirical research indeed shows that LEI promotes some smaller cases.¹⁸⁴ In countries like Germany however, where lawyers enjoy monopoly rights not just for representation in court but also for out of court work, the role of the insurer in the settlement process may be more limited. Empirical research from Germany shows that the trial frequency of claims covered by LEI is somewhat larger than for claims not covered by LEI.¹⁸⁵ Research from the Netherlands shows that court proceedings were started in 4 % of problems for individuals without LEI, and in 6.5 % of problems for individuals with LEI.¹⁸⁶ The difference is more substantial for higher income classes. Note that just like in the case of TPF, the presence of LEI may increase deterrence, and this may have a mitigating effect on the volume of litigation. Hence, one should always be careful in interpreting these numbers: if, under LEI the volume of cases increases that is, from a social welfare perspective not always an undesirable effect. That may be the case if because of LEI claims would be brought with a so-called nuisance value. But precisely because access to justice is costly without LEI there may in fact be too few claims and hence underdeterrence.

4.2. The quality of litigation and the accuracy of settlements

4.2.1. TPF

¹⁸³ See e.g. Shavell, Steven (1982), 'Suit, Settlement and Trial: A Theoretical Analysis under Alternative Methods for Allocation of Legal Costs', 11 *Journal of Legal Studies*, 55-81.

¹⁸⁴ Prais, Vivian (1995), 'Legal Expenses Insurance', in Zuckerman, A. and Cranston, R. (eds.), *Reform of civil procedure: Essays on 'access to justice'*, Oxford, Oxford University Press, 431-46, at 439.

¹⁸⁵ Prais, Vivian (1995), 'Legal Expenses Insurance', in Zuckerman, A. and Cranston, R. (eds.), *Reform of civil procedure: Essays on 'access to justice'*, Oxford, Oxford University Press, 431-46, at 439.

¹⁸⁶ See Klein Haarhuis, Carolien, en Ben van Velthoven, *Legal Aid and Legal Expenses Insurance, Complements or Substitutes? The Case of the Netherlands*, Leiden Law School, Department of Economics Research Memorandum 2010.02, available at <http://media.leidenuniv.nl/legacy/bvv-2010-02.pdf>.

Some commentators expect that TPF will increase the number of lawsuits that have no or dubious legal merit.¹⁸⁷ The reason that this may be the case is that plaintiffs (and their lawyers) are more eager to bring such lawsuits if they are not (fully) financing the cases themselves. It's quite unlikely that consumer legal funding will substantially increase the volume of meritless cases. These loans are typically less than 10 percent of the estimated recoveries in the underlying lawsuits.¹⁸⁸ Regarding loans to plaintiff's law firms, TPF suppliers do not want to lend to law firms who hold many low-probability claims, since the suppliers do not share in the upside potential of these claims. The precise effect on the proportion of lawsuits with low probabilities will depend on the due diligence processes. The situation may be different for investments in commercial claims. Here, TPF suppliers share in the upside potential of the claim. And given that low-probability suits can have high expected profits, TPF suppliers may choose to invest in such cases. Some scholars however doubt that the effect on the volume of low-probability cases will be substantial.¹⁸⁹ First, TPF suppliers seem to find more than enough investment opportunities among claims with relatively high probabilities of recovery. Second, concentrating investments in claims that have high probabilities of recovery may be the best risk-management strategy. It seems that the TPF companies are not sufficiently capitalized to have enough cases in their portfolio so that their portfolio risk is negligible. Juridica for example rejects claims "that raise novel legal questions or that will probably end up before a jury".¹⁹⁰ Of course, in the future, things could change. For now, large capital providers such as banks and insurance companies have stayed away because of the legal uncertainty that surrounds litigation funding.¹⁹¹ If this

¹⁸⁷ See e.g. Beisner, Miller, and Rubin, Paul. 2009. On the Efficiency of Increasing Litigation. Via <http://www.law.northwestern.edu/searlecenter/papers/Rubin-ThirdPartyFinancingLitigation.pdf>.

¹⁸⁸ See Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*, RAND Institute for Civil Justice, OP-306-LFCMP, 2010, 66 pp., ISBN: 978-0-8330-4990-2, p. 30

¹⁸⁹ See Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*, RAND Institute for Civil Justice, OP-306-LFCMP, 2010, 66 pp., ISBN: 978-0-8330-4990-2, p. 32.

¹⁹⁰ See Glater, Jonathan D., "Investing in Lawsuits, for a Share of the Awards," *New York Times*, June 3, 2009, p. B1.

¹⁹¹ See Molot, Jonathan T., "A Market Approach to Litigation Accuracy," 2009b, paper presented at "Third Party Litigation Funding and Claim Transfer—Trends and Implications for the Civil Justice System," RAND Institute for Civil Justice and UCLA Law policy symposium, RAND Corporation, June 2, 2009; Searle Public Policy Roundtable on Third Party Financing of Litigation, Northwestern University Law School, Chicago, Ill., September 24–25, 2009; and U.S. Chamber Institute for Legal Reform, 10th Annual Legal Reform Summit, Washington, D.C., October 28, 2009, p. 32.

uncertainty vanishes, investing in nuisance suits may be a viable business model for these corporations. Also, the high rates of return that current TPF suppliers receive may attract new capital into this market. There could be entry by some suppliers who don't have the skills to evaluate complex cases effectively. This may lead to an increase in lawsuits that lack merit. In the long run however, investing in such cases will lead to losses, and these suppliers will disappear from the market.

Imbalances in risk preferences may skew settlement amounts. A repeat-player defendant who faces many suits from one-time plaintiffs can expect to settle many cases below the mean damages award, since the one-time plaintiff will be more fearful of the worst-case scenario than the repeat-player defendant, who can pool the litigation risks. The problem may be especially large in personal injury lawsuits. For these suits, the spread of possible damages is large and the dispersity between the parties with respect to the ability to cope with litigation risk is enormous.¹⁹² Here, we may expect settlements that reflect bargaining power more than legal merit. Third party financing may promote more accurate settlements by leveling the playing field between plaintiffs and defendants.¹⁹³ However, whether the availability of TPF currently has a significant effect on the accuracy of settlement amounts, is uncertain. In the context of consumer loans, the very high interest rates and the rapid accumulation of interest strips this mechanism of much of its value. Next, investment funds only invest in large commercial claims, not in smaller claims or personal injury claims held by individuals.

4.2.2. LEI

¹⁹² See Jonathan T. Molot, *Litigation Finance: A Market Solution to a Procedural Problem*, 99 *Geo. L.J.* 65-115 (2010). p. 85.

¹⁹³ See Jonathan T. Molot, *Litigation Finance: A Market Solution to a Procedural Problem*, 99 *Geo. L.J.* 65-115 (2010).

It's often alleged that LEI causes a flood of unmeritorious litigation.¹⁹⁴ In theory, a plaintiff may be interested in pursuing a claim that has virtually no chance of winning, because someone else bears the expenditures (the insurer). In reality however, it's highly unlikely that an insurer will provide coverage for weak claims. Legal expenses insurers have a relatively strong incentive to screen cases carefully before granting coverage, since they bear all or most of the costs of a trial, but reap no direct financial benefits.¹⁹⁵ In practice, legal expenses insurers weed out weak cases through various mechanisms. For example, most LEI policies include a deductible.¹⁹⁶ Of course, such a deductible will not only filter out some weak cases, it will also hold back some strong cases with small stakes. Next, LEI policies often include a merits test.¹⁹⁷ In the absence of such a clause in the contract, doctrines of contract law may allow an insurer to decline coverage for unreasonable and futile claims, or for claims that lack evidence.¹⁹⁸ A German research report shows that litigants with LEI win their cases slightly more often (3 %) than self-financing litigants (who paid their lawyers a fixed fee with every stage of the litigation process).¹⁹⁹ This could be a reflection of a more careful case screening. However, the result could also be explained by a selection effect, given that LEI will induce the filing of some strong claims with relatively small stakes (but greater than the deductible).

4.3. The timing of settlements

¹⁹⁴ See e.g. Prais, Vivian (1995), 'Legal Expenses Insurance', in Zuckerman, A. and Cranston, R. (eds.), *Reform of civil procedure: Essays on 'access to justice'*, Oxford, Oxford University Press, 431-46, at 438 and Kilian, Matthias (2003), 'Alternatives to Public Provision: The Role of Legal Expenses Insurance in Broadening Access to Justice: The German Experience', 30 *Journal of Law and Society*, 31-48 at 45.

¹⁹⁵ We can thus expect that legal expenses insurers have a stronger incentive to screen cases than hourly fee lawyers and contingency fee lawyers.

¹⁹⁶ See e.g. Kilian, Matthias (2003), 'Alternatives to Public Provision: The Role of Legal Expenses Insurance in Broadening Access to Justice: The German Experience', 30 *Journal of Law and Society*, 31-48, at 45.

¹⁹⁷ See Kilian, Matthias (2003), 'Alternatives to Public Provision: The Role of Legal Expenses Insurance in Broadening Access to Justice: The German Experience', 30 *Journal of Law and Society*, 31-48.

¹⁹⁸ For example, the contractually implied obligation of good faith. See Colle, Philippe (2005), *Handboek bijzonder gereguleerde verzekeringcontracten*, Antwerpen, Intersentia, at 305.

¹⁹⁹ See Prais, Vivian (1995), 'Legal Expenses Insurance', in Zuckerman, A. and Cranston, R. (eds.), *Reform of civil procedure: Essays on 'access to justice'*, Oxford, Oxford University Press, 431-46, at 439.

4.3.1. TPF

TPF may increase a defendant's willingness to settle at an earlier stage for several reasons.²⁰⁰ First, a defendant who knows that the plaintiff has TPF may realize that certain threats during the negotiations are not credible anymore. In other words, the bargaining power of the defendant may decrease. Also, the willingness of a TPF supplier to fund a case may be regarded by the defendant as a signal that the case is of relative high quality. From empirical research, we know that high-quality cases settle earlier. Fenn and Rickman (1999) find that the more (less) the defendant thinks he is liable, the shorter (longer) is the delay.²⁰¹ Likewise, Fenn and Rickman (2001) find that cases in which the insurer believes its policyholder is fully responsible are associated with shorter delays.²⁰² Finally, Fenn and Rickman (2005) find that cases in which a hospital initially believes it is not liable survive much longer before settling compared to cases where the hospital initially believes it is liable.²⁰³ Furthermore, the arrival of new information weakening the hospital's case speeds up the settlement process and leads to longer durations before a case is dropped. Such a signal may be especially relevant in the segment of investments in commercial claims because of the rigorousness of the due diligence processes. If however investing in nuisance suits may be or become a viable business model for TPF suppliers, then TPF may no longer signal case quality. In the context of consumer legal funding, TPF may decrease the proportion of plaintiffs that are eager to settle early, because the loans enable plaintiffs to pay their bills in the interim. Also, TPF may sometimes reduce the willingness of a plaintiff to settle late in the life of the underlying claim, because the amount owed to the TPF supplier can eventually exceed what the defendant is willing to offer during settlement. The plaintiff may then prefer to go to trial, hoping for a recovery that is larger than amount owed to the TPF supplier.

²⁰⁰ See Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*, RAND Institute for Civil Justice, OP-306-LFCMP, 2010, 66 pp., ISBN: 978-0-8330-4990-2, p. 32-34.

²⁰¹ Fenn, P. and Rickman, N., 'Delay and Settlement in Litigation', 109 *Economic Journal*, 1999, p. 487.

²⁰² Fenn, P. and Rickman, N., 'Asymmetric Information and the Settlement of Insurance Claims: Theory and Evidence', 68(4) *Journal of Risk and Insurance*, 2001, p. 627.

²⁰³ Fenn, P. and Rickman, N., 'Legal Liability and the Timing of Settlement in Medical Malpractice', 2005, p. 21, available online via <http://law.bepress.com/cgi/viewcontent.cgi?article=1543&context=alea>.

Apart from the initial and the later phase of the settlement stage, consumer legal funding may promote (earlier) settlements during the period in between due to the rapid rate at which a plaintiff's debt to a TPF supplier increases. Likewise, a law firm paying interest on a loan may have a relatively strong incentive to settle quite early so it can repay its debt from the proceeds.

4.3.2. LEI

An empirical study by Fenn e.a. (2005) finds that claims with LEI in England and Wales settle faster than claims funded by other means.²⁰⁴ This can be explained quite easily. The insurer internalizes the full (or a large part of the) costs of the settlement stage. He thus has every incentive to settle early. This effect will be largest if the insurer is in charge of the settlement negotiations.²⁰⁵ ²⁰⁶ But also if an outside lawyer is in charge of the settlement negotiations, the case may still settle earlier than cases that are not funded by LEI. The reason is that the insurer is probably in a better position to control for lawyer opportunism than an individual (without LEI). The lawyer monitored by an insurer will shirk less and will settle a case sooner on average.

4.4. The costs of (individual) disputes

4.4.1. TPF

²⁰⁴ Fenn, Paul, Gray, Alistair, Rickman, Neil and Mansur, Yasmeen (2005), The funding of personal injury litigation: comparison over time and across jurisdictions, Report to the DCA, October 2005, via http://webarchive.nationalarchives.gov.uk/+http://www.dca.gov.uk/research/2006/02_2006.pdf.

²⁰⁵ In Belgium for example, lawyers' monopoly rights only extent to representation in court. In the context of LEI, legal services are often provided by in-house salaried personel.

²⁰⁶ Of course, an important limitation is that policyholders always have the right to free choice of counsel from the moment they are involved in judicial or administrative proceedings. See Art. 4.1 (a) Directive 87/344/EC on the Coordination of Laws, Regulations and Administrative Provisions relating to Legal Expenses Insurance, official reporter EC Nr. L 185, 4 July 1987, 77.

Generally speaking, whether and how TPF will influence the costs of individual disputes, depends on whether TPF suppliers are able to influence how cases are pursued.²⁰⁷ Unfortunately, this is unknown.²⁰⁸ Next, expenditures will generally increase whenever TPF is sought primarily to loosen cash-constraints (this can be either the case for loans to consumers, loans to plaintiff law firms and investment in commercial litigation). Cash-constrained plaintiffs tend to invest less in out-of-pocket expenses (e.g. expert consultants and witnesses). Regarding investments in commercial litigation, the effect on the expenditures depends to a large extent on the share of the recovery and of the costs for the TPF supplier.

4.4.2. LEI

Obviously, we can expect LEI to increase the costs of individual disputes. When not insured, a plaintiff has to pay for each additional hour his lawyer spends on the case himself. When insured, the plaintiff can use LEI staff, or if necessary a lawyer, at no or a much lower cost. Recent Dutch empirical research confirms this, at least for the high income class.²⁰⁹ The intensity of the contacts with legal advisors is significantly higher for the highest income earners once they are insured (2.09 contacts versus 1.73 contacts). For lower income classes, the impact of LEI is mainly by substitution. The direct assistance of LEI staff comes, to a large extent, in place of the subsidized lawyer. The researchers are aware that other factors may have played a role in the use of legal advisers. After controlling for other relevant factors like type of problem, gravity and complexity of the problem, expected revenue and personal characteristics, multivariate analysis

²⁰⁷ It may also depend on whether TPF suppliers provide information to lawyers that helps them make a more productive use of time and money.

²⁰⁸ See See Steven Garber, *Alternative Litigation Financing in the United States: Issues, Knowns, and Unknowns*, RAND Institute for Civil Justice, OP-306-LFCMP, 2010, 66 pp., ISBN: 978-0-8330-4990-2, p. 35.

²⁰⁹ See Klein Haarhuis, Carolien, en Ben van Velthoven, *Legal Aid and Legal Expenses Insurance, Complements or Substitutes? The Case of the Netherlands*, Leiden Law School, Department of Economics Research Memorandum 2010.02, available at <http://media.leidenuniv.nl/legacy/bvv-2010-02.pdf>, p. 10.

corroborates their findings.²¹⁰ Given that a person actively responds to a justiciable problem, LEI increases the chance that a person will seek (more) legal advice. Income is an important factor when people are not insured: the number of contacts with legal advisers decreases with income. When individuals are insured, the effect of income is insignificant.

CONCLUSION

We have compared TPF with another important mechanism which can be used to finance litigation, more particularly LEI. We started by presenting a few facts indicating that both in Europe and in the US LEI is underused. Even in countries where there is a relatively high coverage of LEI (such as Germany) one could expect an even higher coverage given the generous regulatory environment for LEI. Only countries where LEI mandatory (as an add on to household insurances, like in Sweden) have a wide coverage. This brought us to the question whether the reasons that may explain the low coverage for LEI also apply in the case of TPF. A comparison in that respect is rather difficult since TPF (so far) is only used in a few jurisdictions, the regulatory environment in Europe is not very receptive towards TPF and both TPF and LEI have many different appearances. Generally, we concluded that many of the problems that may cause a low coverage for LEI do not influence TPF to the same extent. One reason for this is that LEI and TPF are instruments with not entirely identical goals. Whereas LEI aims at coping with uncertainty before a risky event concerning litigation costs may occur, TPF is used ex post (after the event) and rather meant as a financing instrument than as a remedy for risk aversion (like traditional insurance instruments). We have also briefly compared the pros and cons of both LEI and TPF. However, given the relatively recent history of TPF one has to be very cautious in this respect. Contingency fees are used in the US for more than half a century and still today there is large disagreement in the empirical law and economics literature on the precise effects of such

²¹⁰ See Klein Haarhuis, Carolien, en Ben van Velthoven, Legal Aid and Legal Expenses Insurance, Complements or Substitutes? The Case of the Netherlands, Leiden Law School, Department of Economics Research Memorandum 2010.02, available at <http://media.leidenuniv.nl/legacy/bvv-2010-02.pdf>, p. 11.

fees. The same can be said for TPF as well: since it is still a relatively recent phenomenon and can appear under different forms, it is not possible to argue generally that TPF should be preferred to LEI or the other way around. However, we have seen that TPF does not necessarily do worse than LEI as far as e.g. the volume of litigation, the quality of litigation and the timing of settlements is concerned. So far legal systems in Europe are rather hostile towards TPF: many countries consider financing someone else's legal claim as being against public policy. However, given low coverage of LEI and reduced legal aid in many systems, even though TPF may not have as primary function to promote access to justice, it can effectively serve that goal. For example, by providing the possibility of upfront payment to plaintiffs, litigation can be made more attractive, even when it is used in combination with other techniques like contingency fees. TPF thus certainly merits further analysis and could serve important social goals in promoting access to justice and hence providing further deterrence, reducing accidents and personal injury.