Legal Expenses Insurance versus Third-Party Financing of Litigation

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INTRODUCTION

For decades there have been some remarkable differences between the U.S. and many European countries in the way that lawsuits are funded. For example, in the U.S., neither the federal government nor any state has enacted a statutory right to counsel in civil cases.[1] Nearly all European nations have enacted statutory rights to counsel in criminal and civil cases.[2] In the U.S., contingency fees are allowed, and they offer a solution in many cases, especially for plaintiffs with limited financial means.[3] On the other hand, most European countries do not allow contingency fees.[4] Some recent trends in litigation financing in the U.S. and in Europe may increase the differences in these two approaches to litigation funding. In the U.S., legal expenses insurance (LEI) for bringing claims is virtually absent,[5] but third-party litigation funding (TPF) is

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[1] Earl Johnson, Jr., *Justice, Access to: Legal Representation of the Poor, in* INTERNATIONAL ENCYCLOPEDIA OF THE SOCIAL AND BEHAVIORAL SCIENCES 8048, 8049-53 (Neil J. Smelser and Paul B. Baltes eds., 2001) (In the U.S., private charity was the only source of legal counsel for the poor during most of its history. Many states and cities have organized pro bono programs. Others require private lawyers to report on the hours devoted to pro bono services. These pro bono legal services only play a limited role in the delivery of access to justice.).

[2] *Id*. at 8049 ("England's first such statute was enacted in 1495, France in 1852, Germany in 1877, the rest of Northern Europe in the early twentieth century, [and] Italy in 1923.").

[3] JOHNSON, *supra* note 1, at 8051.

[4] *See, e.g.*, Michael G. Faure et al., *No cure, no pay and contingency fees*, *in* NEW TRENDS IN FINANCING CIVIL LITIGATION IN EUROPE: A LEGAL, EMPIRICAL, AND ECONOMIC ANALYSIS 33, 33 (Mark Tuil and Louis Visscher eds., 2010).

[5] *See* Matthias Kilian, *Alternatives to Public Provision: The Rule of Legal Expenses Insurance in Broadening Access to Justice: The German Experience*, 30 J.L. & SOC'Y 31, 36 (2003).

a growing phenomenon.[6] 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."[7] Therefore, this term refers to financing by those other than plaintiffs, defendants, insurers, and lawyers.[8] Although TPF is not widespread, it is 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 in the traditional lending market to fund litigation.

Although many European countries still provide generous legal aid, others have pushed or are seriously considering pushing consumers into entering private insurance arrangements to guarantee access to the courts. For example, before December 1, 1997, most Swedes could rely on public legal aid when they needed legal advice or a lawyer to go to court.[9] Since that day, however, most Swedes have had to rely on their mandatory legal expenses insurance policy to have access to legal services.[10] A 2007 report prepared on behalf of the UK's Ministry of Justice concludes that legal insurance is an underexplored means of promoting access to justice.[11] The report also offers different suggestions to promote LEI to a broader public.[12] [13] Briefly

[6] Paul H. Rubin, *On the Efficiency of Increasing Litigation*, presented at the Third Party Financing of Litigation Roundtable, Searle Ctr., Nw. Univ. Law Sch. (Sept. 2009) , http://www.law.northwestern.edu/searlecenter/papers/Rubin-ThirdPartyFinancingLitigation.pdf.

[7] STEVEN GARBER, *Alternative Litigation Financing in the United States: Issues, Knowns and Unknowns*, RAND CORP. 1 (2010).

[8] Lawyer funding is more common in the U.S. than in Europe. For an overview of contingency fees in Europe see Faure et al., *supra* note 4, 33-56.

[9] Francis Regan, *The Swedish Legal Services Policy Remix: The Shift from Public Legal Aid to Private Legal Expenses Insurance*, 30 J.L. & SOC'Y 49, 50 (2003).

[10] *Id*.

[11] OONA MCDONALD, IAN WINTERS & MIKE HARMER, THE MARKET FOR 'BTE' LEGAL EXPENSES INSURANCE, MINISTRY OF JUSTICE 51-56 (July 2007), http://www.justice.gov.uk/publications/docs/market-bte-legal-expenses-insurance-a.pdf.

[12] *Id*.http://www.justice.gov.uk/publications/docs/market-bte-legal-expenses-insurance-a.pdf.

[13] 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

summarized, the trend in Europe reflects an ex ante approach to funding of litigation, whereas the trend in the U.S. reflects an ex post approach.

This article compares TPF and LEI from an economic perspective. Such a comparison deserves attention for at least two reasons. First, as this article will argue, LEI is not particularly widespread in Europe, as is often alleged. In most European countries in which the government does not push LEI (e.g., by making it compulsory), LEI is not that common.[14] The possibility of entering into contingency-fee contracts cannot explain this phenomenon because such contracts are forbidden in most European countries.[15] Also, even though one would expect a large fraction of households in European countries with limited legal aid budgets to be covered by LEI, this is not always the case. For example, in Belgium, where contingency fees are prohibited, only 20% of the population is covered by public legal aid.[16] The number of Belgians having LEI, however, is quite low.[17] This raises the question whether the market for LEI suffers from market failure, and if a failure in the market for LEI could hinder the development of the market for TPF. We will discuss the following potential reasons for the limited supply of LEI and TPF: the existence of alternatives for access to justice, adverse selection, moral hazard, and the free rider problem.

An economic comparison of TPF and LEI may also shed light on the relative social costs of TPF and LEI. The social efficiency of TPF has been intensely debated in the recent literature,[18] and many advantages and disadvantages have been examined.[19] This article will

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law. The Law Society of Upper Canada and LAO should accord a high priority to promoting the role of legal insurance in Ontario." MICHAEL TREBILCOCK, INNOVATIONS IN SERVICE DELIVERY, MINISTRY OF THE ATTORNEY GENERAL, http://www.attorneygeneral.jus.gov.on.ca/english/about/pubs/trebilcock/section7.asp (last visited Dec. 30, 2011).

[14] For data, see further.

[15] Faure et al., *supra* note 4.

[16] See http://www.nieuwsblad.be/article/detail.aspx?articleid=DMF06102006_004.

[17] For details on premium income per capita see CEA INUSRERS OF EUROPE, CEA STATISTICS N°37: EUROPEAN INSURANCE IN FIGURES 9 (2009) *available at* http://www.cea.eu/uploads/Modules/Publications/eif-2009.pdf.

[18] For an overview, see STEVEN GARBER, *Alternative Litigation Financing in the United States: Issues, Knowns and Unknowns*, RAND CORP. 1 (2010).

examine to what extent TPF and LEI differ with respect to these advantages and disadvantages. It 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 decide whether or not to stimulate TPF (e.g., through relaxing some current legal restrictions) and/or legal expenses insurance (e.g., by a tax deduction).

Section I provides data, facts, and the legal background for both LEI and TPF. It examines differences between LEI in the U.S. and in Europe in greater detail, showing great differences between the U.S. and Europe as well as between individual European countries. LEI for bringing a claim is not only quite rare in the U.S.,—at least in its pure form, but also in many European countries. Furthermore, in those European countries where a large fraction of households have LEI, this is due to the intervention of policymakers. Section II examines several potential reasons why LEI markets and policies may be underdeveloped. It discusses why most of those reasons cannot fully explain the low prevalence of LEI and analyzes whether these factors could hinder the development of TPF. Finally, section III examines the advantages and disadvantages of the *ex ante* approach—LEI—and the ex post approach—TPF.

I. LEI AND TPF IN THE US AND IN EUROPE: LEGAL FRAMEWORK, FACTS AND DATA

A. *LEI*

1. General remarks

Generally, LEI is "a voluntary private insurance that covers the costs of lawsuits."[20] It is also known as legal cost insurance, legal protection insurance, or simply legal insurance.[21] In

[19] *Id.*
[20] Thomas Raiser, *Legal Insurance, in* INTERNATIONAL ENCYCLOPEDIA OF THE SOCIAL AND BEHAVIORAL SCIENCES 8638, 8638 (Neil J. Smelser and Paul B. Baltes eds., 2001).
[21] *Id.*

France, LEI is called *L'assurance de protection juridique*.[22] In Germany it goes by *Rechtsschutzversicherung*.[23] Directive 87/344/EEC of June 22, 1987 of the European Union on the coordination of laws, regulations, and administrative provisions relating to LEI defines the termas 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.[24]

This article focuses on LEI for *bringing* claims, as LEI for *defending* against claims is almost always part of liability insurance contracts.[25] Furthermore, it focuses on before-the-event (BTE) insurance, not after-the-event (ATE) insurance. BTE insurance is taken out by individuals wishing to protect themselves against potential litigation costs that could be incurred following a future event.[26] ATE insurance covers future legal expenses in a case where a dispute has already occurred, such as an accident that has caused an injury.[27] It is also important to distinguish between *add-on* LEI and *stand-alone* LEI. The former is added on to existing policies that already have a high market penetration, such as household insurance and motor vehicle insurance.[28] Stand-alone policies, however, are concluded separately from any other insurance

[22] CODE DES ASSURANCES [C. ASS.] art. L127-1.
[23] *Id*.
[24] Council Directive 87/344/EEC, art. 2, 1987 O.J. (L 185) 2 (EC).
[25] See Willem H. Van Boom, *Financing civil litigation by the European insurance industry*, *in* NEW TRENDS IN FINANCING CIVIL LITIGATION IN EUROPE: A LEGAL, EMPIRICAL, AND ECONOMIC ANALYSIS, 93 (Mark Tuil and Louis Visscher eds., 2010)
[26] *See* Kilian, *supra* note 5, at 33.
[27] *Id*. 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.
[28] Francis Regan, *Whatever Happened to Legal Expenses Insurance?*, 26 ALT. L.J. 293, 294 (2001).

agreement.[29] Most current LEI policies are of the add-on type.[30] Finally, a distinction can be made between *pure forms* of LEI and *legal services plans*.[31] The pure form of LEI originated in Europe and still predominates there.[32] It applies principles present in other forms of insurance.[33] The pure form of LEI is a means of financing the often unpredictable costs of civil lawsuits, as it spreads the risk of these costs among all policyholders. Legal services plans, on the other hand, do not use insurance principles, but rather create benefits for policyholders by relying on bulk savings.[34] These plans are found mainly in the U.S. and Canada.[35]

2. United States

When discussing LEI in the U.S., it is necessary to distinguish between group legal services plans and prepaid legal services plans, both of which play a sizable role in the American legal system. In 1999, approximately 110 million Americans were estimated to be covered by some type of legal coverage (personal, business, union, military, or employee) plan.[36] In 2002, 122 million Americans were covered by a group legal service plan (68 million) or prepaid legal services plan (54 million).[37]

Group legal services plans usually offer free consultations and discounts on legal services to members of groups that sponsor the plans (e.g., unions and membership organizations such as

[29] *See id*.
[30] *The Legal Protection Insurance Market in Europe*, RIAD INT'L ASS'N OF LEGAL EXPENSES INS. 14 (June 2010), *available at* http://www.riad-online.net/fileadmin/documents/homepage/publications/Annual_Reports/RIAD-Legal-Protection-Market_June2010.pdf.
[31] Francis Regan, *Whatever Happened to Legal Expenses Insurance?*, 26 ALT. L.J. 293, 294 (2001).
[32] *Id.*
[33] *Id.*
[34] Regan, *supra* note 29, at 294.
[35] *Id*.
[36] 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 (citing figures gathered by the National Resource Center for Consumers of Legal Services).
[37] Moore, *supra* note 37, at 1-2. The figure equals 154 million if duplicates are counted. *Id.*

the American Association of Retired Persons (AARP)).[38] The members generally only pay the membership fee to join the group and then access the legal services for free.[39] Discounts are based on the participating lawyers' usual fees.[40] In 2002, the top four group legal services plans covered more than 90% of individuals enrolled in such plans: the Union Plus Legal Services Plan (45%), the AARP plan (20%), the elder hotlines (20%) and the plan sponsored by the National Education Association (6%).[41]

Prepaid legal services plans, on the other hand, are generally sold by companies that contract with lawyers in private practices to provide the services. The larger union plans mainly offer legal counseling through their own employees. These employees may be attorneys, but often they are not and have little or no formal legal education.[42] Most prepaid plans are offered to employees by their employers as part of a benefit package, sold either directly to employees by their employers at special rates, or sold directly to the public.[43] In general, the prepaid plans are limited in scope and only provide low-cost assistance for routine legal matters.[44] For example, members of AARP receive up to forty-five minutes of free consultation, low cost simple wills and powers of attorneys, and a 20% discount on all other services provided by participating attorneys.[45]

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[38] *See* Wayne Moore, *The Impact of Group and Prepaid Legal Services: Plans to Meet the Needs of Middle Income People*, 2003, at 1, *available at* http://www.ilagnet.org/jscripts/tiny_mce/plugins/filemanager/files/Harvard_2003/Conference_Papers/The_Impact_of_Group_and_Prepaid_Legal_Services_part1.pdf.

[39] *Id.*

[40] *Id.*

[41] Wayne Moore, *The Impact of Group and Prepaid Legal Services: Plans to Meet the Needs of Middle Income People*, 2003, at 1, *available at* http://www.ilagnet.org/jscripts/tiny_mce/plugins/filemanager/files/Harvard_2003/Conference_Papers/The_Impact_of_Group_and_Prepaid_Legal_Services_part2.pdf.

[42] Raiser, *supra* note 21, at 8639.

[43] Moore, *supra* note 37, at 1.

[44] DONALD L. CARPER, JOHN A. MCKINSEY & BILL W. WEST, UNDERSTANDING THE LAW 157 (5th ed. 2008).

[45] AARP – LEGAL SERVICES NETWORK, http://www.aarplsn.com/lsn/jsp/benefits.jsp (last visited Dec. 30, 2011).*http://www.aarp.org*

3. Europe

The main obligations on insurance companies that offer LEI in European countries can be found in Directive 87/344/EEC of June 22, 1987 of the European Union, which discusses the coordination of laws, regulations, and administrative provisions relating to LEI.[46] National regulations, apart from the ones implementing this directive, generally do not contain many specific provisions dealing with LEI.[47] First, the EU directive requires insurance companies to provide a separate contract or a separate section of a single policy for LEI. Second, to mitigate the risk of conflicts of interest, insurance companies must either (a) have separate management for LEI, (b) entrust the management of claims with respect to LEI to a company with a separate legal identity; or (c) must afford the insured the right to entrust the defense of his interests to a lawyer of his choice, from the moment that he has the right to claim from his insurer under the policy. In all cases where recourse to a lawyer is available, the insured must have the right to choose his lawyer. Finally, in the event of a conflict of interest or a disagreement over settlement of the dispute, the insurer must inform the insured of his right to choose his lawyer freely and of the possibility of using an arbitration procedure. With respect to mass claim actions, the European Court of Justice (ECJ) recently had to decide whether clauses that entitle insurers to limit their performance to the bringing of test cases, or where appropriate, to collective redress or other ways of asserting legal interests by legal representatives selected by them, are a permissible limitation of the insured's rights where the interests of several insured persons are directed against the same opponents.[48] The ECJ ruled that they are not.

[46] 1987 O.J. (L 185) 77-80.
[47] McDonald et al., *supra* note 12, at 48.
[48] Case C-199/08, Eschig v. UNIQA Sachversicherung AG, 2009 E.C.R. I-08295.

Turning from the legal framework to facts and data, we start with the UK, where BTE insurance has been available for more than thirty-five years.[49] BTE is sold in a variety of ways. First and foremost, insurance companies sell it as an add-on to motor or household insurance (i.e., as an optional policy). Only some insurers incorporate it into the household insurance policy. In 2005, 75% of all households had home contents insurance.[50] Many people do not take the BTE option, however. BTE is also sold directly through banks and building societies, or attached to travel insurance. For employment matters, people sometimes have access to BTE through membership in a trade union or other affinity group. BTE 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 policies remains low—about 2% of households[51]—with the exception of commercial policies. With respect to add-ons, more UK households take BTE as an add-on to motor insurance rather than to household insurance. In 2006, about 18.5 million UK consumers held BTE as part of their car insurance, another 14.2 million bought BTE as an add-on to their household insurance, and 4.7 million more purchased BTE with their travel insurance.[52] The UK population is about 62 million. BTE as an add-on to household insurance offers more extensive coverage than the standard add-on to a motor policy.[53] A BTE policy added to household insurance generally covers personal injury, property protection, tax protection, employment disputes, contract disputes, and certain aspects of legal defense. 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

[49] McDonald et al., *supra* note 12, at 11.
[50] *Id.* at 11.
[51] *Id.* at 39.
[52] *Id.* at 12.
[53] *Id.*

occur under a personal BTE policy are: personal injury (50%), consumer disputes (16%), employment disputes (20%), property disputes (8%), and medical negligence (6%).[54] The policy limits are not always very high.

France was the first European country where LEIproducts were offered.[55] In 2008, there were 5.4 million stand-alone LEI contracts (with an average premium of €62) and 15 million LEI policies added to general household insurance (with an average premium of €20 for the add-on).[56] The low average premiums, together with the fact that LEI only provided for 2.5% of French lawyers' incomes and plaintiffs have some form of LEI in only 2% of French court cases, demonstrate that LEI'seconomic importance in France is very modest.[57]

The German market for LEI is dominated by stand-alone policies. Most stand-alone policies do not cover all domains of law, allowing policyholders to choose *a la carte* from several areas of coverage according to their needs (e.g., property law, contract law, employmentlaw).[58] The policies do not cover abstract legal advice—an insured event must occur first.[59] Given the extensive monopoly rights held by German lawyers, in-house lawyers do not deal with cases. Routine transactions, such as legal advice and assistance with documents, are

[54] *Id.* at 47.

[55] Kilian, *supra* note 5, at 32. In France, LEI is regulated by the Loi portant réforme de l'assurance de protection juridique. Loi 2007-210 du 19 février 2007 portant réforme de l'assurance de protection juridique [Law 2007-210 of Feb. 19, 2007 on Reform of Legal Expenses Insurance], JOURNAL OFFICIEL DE LA RÉPUBLIQUE FRANÇAISE [J.O.] [OFFICIAL GAZETTE OF FRANCE], Feb. 21, 2007, p. 3051.

[56] Bernard Cerveau, *Aide Juridictionnelle et Assurance de Protection Juridique*, at 5, http://www.avocats-lille.com/doc/aj/AJ_assurance_protection_juridique.pdf (last visited Dec. 30, 2011). In 2005, 21 percent of households had legal expenses insurance. Marie-Hélène Beaulieu & Jacinthe Lauzon, *L'assurance juridique: une solution pour une meilleure accessibilité à la justice?* (Mar. 2007), at 21, http://www.option-consommateurs.org/documents/principal/fr/File/rapports/assurances/oc_assurance_juridique_200704.pdf.

[57] 360,000 cases were opened, 60,000 ended up in court. *See* Cerveau, *supra* note 61, at 5.

[58] Kilian, *supra* note 5, at 34.

[59] *See* van Hubert W. van Bühren, *Das rechtsschutzversicherte Mandat*, 52 MONATSSCHRIFT FÜR DEUTSCHES RECHT 745, 748 (1998).

rarely covered by such stand-alone policies. In 2000, 42% of households were covered by stand-alone LEI policies,[60] a figure that rose to 44% in 2004.[61]

In the early 1970s, Sweden introduced one of the most comprehensive and generous legal aid schemes in the world. The legal aid scheme, which included advice and assistance related to litigation, was made available to most Swedes and covered most legal problems.[62] In 1997, the Swedish government radically reformed its legal services policy and drastically reducedpublic expenditures on legal aid. The relationship between public legal aid and private forms of financing legal assistance was reversed. Since December 1, 1997, most Swedes have had to use their LEI policy to access legal services.[63] However, this has not proven to be a great burden, as 97% of Swedes are covered by LEI.[64] The pervasiveness of LEI in Sweden is attributable to the fact that coverage for legal expenses is automatically included in household insurance policies.

Data from the Commitée Européen des Assurances (CEA) demonstrate that LEI represented only 1% of total European insurance premiums in 2008.[65] The CEA data also demonstrates the growth of LEI premium expenditures between 2000 and 2008 for several European countries. On the basis of this data, it is apparent that although LEI is becoming more widespread in Europe, its impact in absolute terms remains modest.

Country	**Premium expenditure per**	**Premium expenditure per**

[60] The figure is for the year 2000. *See* Kilian, *supra* note 5, at 38.
[61] *See* Matthias Kilian & Francis Regan, *Legal Expenses Insurance and Legal Aid – Two Sides of the Same Coin? The Experience from Germany and Sweden*, 11 INT'L J. LEGAL PROF. 233, 238 (2004).
[62] Regan, *supra* note 10, at 52.
[63] *Id.* at 50.
[64] *See* C.M.C. van Zeeland & J.M. Barendrecht, *Legal Aid Systems Compared*, (2003), http://www.tilburguniversity.nl/faculties/law/research/tisco/publications/reports/legal-aid-systems.pdf *available at* http://arno.uvt.nl/show.cgi?fid=11571.
[65] *See* CEA INUSRERS OF EUROPE, CEA STATISTICS N°37: EUROPEAN INSURANCE IN FIGURES 9 (2009) *available at* http://www.cea.eu/uploads/Modules/Publications/eif-2009.pdfhttp://www.cea.eu/uploads/Modules/Publications%5Ceif-2009.pdf.

	capita 2008 (Euro)[66]	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

4. Discussion

At first sight, the differences between LEI in the U.S. and in Europe could not be greater. American group and prepaid legal services plans are not truly insurance policies and only cover a limited amount of services, whereas the European LEI policies seem much broader. However, 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 services do not face any inherent obstacles to development. However, as has been explained before, Swedish LEI policies are automatically added on to household insurance policies which already have a large market penetration. Swedes do not have the option to purchase household insurance without LEI.[67] LEI is integrated in these policies "for free."

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

[67] The Swedish model is hence what is referred to as compulsory add-on insurance: LEI is automatically added on to voluntary purchased insurance policies with a high market penetration. LEI in Sweden is supposedly added "for free," but because it is automatically added on to the household insurance, the reality is that the price for LEI is included in the premium for the basic insurance. It is hence obviously not "free," but rather not directly visible. *See* Regan, *supra* note 29, at 294.

Additionally, many cases are excluded (including divorce).[68] This can be explained historically. The Swedish labor movement promoted LEI in the 1960s because legal aid, focused on low-income people, failed to reach middle-income earners.[69] LEI was designed to cover problems, costs, and groups that were excluded from legal aid. These policies were rather modest, as the legal aid regime at the time was quite comprehensive. Finally, claims on LEI require policyholders to pay an upfront fee along with a fraction of the estimated costs of the case.[70]

In Germany, other non-compulsory insurances are much more popular than LEI. For example, "65 percent of all households have a [sic] general liability insurance and 75 percent have a [sic] household insurance."[71] Research by Kilian (2003) shows that we should expect the demand for LEI to be high in Germany. The regulatory environment in Germany is very favorable for the development of the LEI market because:[72] (1) the German government only spends a modest amount on legal aid; (2) almost all forms of output-based remuneration are prohibited including not only contingent fees, but also conditional fees[73] and success fees; (3) even a party enjoying legal aid who loses her claim has to pay her opponents' costs and only her own lawyer's and court fees are covered by legal aid; (4) lawyers enjoy monopoly rights for out of court work (not just for representation in court but also for e.g. legal advice), making it virtually impossible to obtain lower-priced legal advice from non-lawyers (e.g. paralegals); (5) the existence of a very formal and transparent fee regulation, laid down in the Bundesrechtsanwaltsgebührenordnung (BRAGO, German Federal Code of Lawyers' Fees), that

[68] Kilian and Regan, *supra* 69, at 15-16.
[69] *Id.* at 14.
[70] *Id.* at 16.. There is also a ceiling on the amount that can be claimed per year.
[71] Kilian, *supra* note 5, at 38.
[72] *See Id.* at 43-44.
[73] Under a conditional fee, the lawyer gets nothing if he loses the case, and an uplift on his normal fee if he wins the case. Unlike under contingency fees, the uplift does not depend on the amount at stake.

gives insurance companies a good idea of the ultimate risk and simplifies the calculation of premiums; and (6) the German Bar has very little reason to oppose a shift from public legal aid to private insurance.[74] 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 the German Bar opposes the development of LEI depends primarily on three factors. The first, factor is 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 in-court representation, they have more to lose when LEI 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.[75] The second, factor is whether the insured can freely choose the lawyer that will handle their case. When insurance companies need to hire a lawyer (whether mandated to do so or in complex cases where a settlement cannot 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 insurance companies to create competition between different lawyers and law firms.[76] The third factor is whether the government has established 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. Minimum fees and monopoly rights for out of court

[74] Kilian, *supra* note 5, at 43-44.

[75] *See* Michael G. Faure, Ton Hartlief and Niels Philipsen, *Funding of Personal Injury Litigation and Claims Culture. Evidence from the Netherlands*, 2 UTRECHT L. REV. 1 (2006).

[76] Council Directive 87/344EEC of 22 June 1987 on the coordination of laws, regulations and administrative provisions relating to legal expenses insurance 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. 1987 O.J. (L 185) 77-80.

work protect German lawyers from the competitive effects that otherwise would result from the insured being able to choose a lawyer.[77]

B. *TPF in the United States*[78]

The current TPF industry in the U.S. can be divided into three relatively active segments: (1) consumer legal funding (non-recourse loans) to individuals, usually personal injury plaintiffs; (2) loans and lines of credit for plaintiffs' law firms; and (3) investments in commercial lawsuits.[79] All of these segments of the TPF industryprovide financial support for plaintiff-side efforts.[80] Presently, there is very little TPF for American defendants,[81] although some providers of plaintiff-side TPF are also interested in providing funding to defendants and their lawyers.[82] For now, TPF does not seem like it will play an important role in the U.S. class action market,[83] as a number of investment firms have claimed that they do not intend to enter that market.[84] In the context of consumer legal funding, a consumer's potential recovery from a class action may seldom be large enough to obtain a non-recourse loan.

[77] Kilian, *supra* note 5, at 37-38, 44.

[78] This section briefly describes the TPF industry and its regulatory environment in the U.S.. For more elaborate studies and for a description of TPF in other countries, see the other articles in this issue.

[79] Because of time and space constraints, we focus on the main forms of TPF in the U.S. 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 twenty days before the catastrophe. This can be explained by a comparative advantage in claims administration. *See* David Mayers & Clifford W. Smith, *On the Corporate Demand for Insurance*, 55 J.OF BUS. 281, 285 (1982). Without the extra coverage, the incentives of the insurance company's adjusters' to negotiate efficient settlements could be far from optimal.

[80] *See* GARBER, *supra* note7, at x.

[81] 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).

[82] *See* Ralph Lindeman, *Third-Party Investors Offer New Funding Source for Major Commercial Lawsuits*, DAILY REP. FOR EXECUTIVES (BUREAU OF NAT'L AFF.), March 5, 2010, at 3.

[83] *See* GARBER, *supra* note 7, at 36.

[84] Deborah R. Hensler, *The Future of Mass Litigation: Global Class Actions and Third-Party Litigation Funding*, 79 GEO. WASH. L. REV. 306, 323 (2011).

Dozens of TPF companies provided funding to consumers with pending legal claims[85] in 2010.[86] As the great majority of these lawsuits involve personal injury claims (mainly auto accidents) and only consumers who have found a lawyer who has agreed to represent the client are eligible for funding, almost all of these consumers are being represented on a contingency-fee basis.[87] Typically, the TPF company provides funds to the consumer in exchange for a promise to pay back the funds plus a contracted fee.[88] Although the fee does not depend on the amount of the recovery, it typically increases with the time elapsed.[89] The contracts are typically non-recourse loans, meaning that the consumer is never obligated to pay more than the proceeds from the underlying lawsuit. The financing fees can significantly exceed interest rates on consumer bank loans or on credit card balances.[90] Typical rates would be 3 to 5% monthly interest,[91] although some companies charge less than 2%. The average size of the cash advance tends to be less than 10% of estimated values of the underlying claim.[92] Consumers may be interested in these loans because their ability to obtain funding from other sources is exhausted or they like 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.[93] A law firm's debts are typically secured by all of the firm's assets, including its real property and future fees from its cases. Little is known about the interest rates charged to firms, but interest

[85] Many other terms besides consumer legal funding are used by TPF companies and others: e.g. cash advances, legal funding, and plaintiff funding.
[86] Some contracts are made after the case is settled because it can take months before the settlement payment is made.
[87] Since most personal injury lawyers work on a contingency fee basis.
[88] See GARBER *supra* note 7 at 9.
[89] *See* GARBER, *supra* note 7, at 9.
[90] GARBER *supra* note 7 at 10.
[91] *See* JONATHAN T. MOLOT, A MARKET APPROACH TO LITIGATION ACCURACY, at 24 (Geo. Univ. L. Ctr., 2009), *available at* http://www.law.northwestern.edu/searlecenter/papers/Molot_Accuracy.pdf.
[92] *See* GARBER, *supra* note 7, at 12.
[93] In 2010, there were 9 TPF companies in this segment. *See* GARBER, *supra* note 7, at 13.

Met opmaak: Engels (V.S.)

rates of about 20% appear to be common.[94] Law firms' motives to use this type of funding are the desire to remain solvent, alleviate cash-flow problems, compete for business with firms that have more capital, and invest more in pending cases.[95]

Garber (2010) identified six companies that provide capital directly to businesses-plaintiffs or their outside counsel to finance costs of pending commercial claims (business-against-business).[96] The disputes are usually antitrust, intellectual property, or contracts cases. The TPF companies provide capital in return for a share of the corporate plaintiff's recovery, hence the term *investment* for these transactions. Several motives have been advanced to explain why companies consider this type of funding. Some companies may want to use less of their own capital to pay outside counsel.[97] Others may want an assessment of the merits and economic value of their claim in addition to the one provided by their outside counsel.[98] 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.[99] And last, corporate general counsel may be loath to ask for a budget increase.[100]

The legal status of TPF in the United States is unclear.[101] Laws governing TPF agreements vary widely among states. Only a few states have adopted regulations specifically for TPF.[102] These statutes generally focus on loans in personal injury cases, not on commercial litigation. To date, no U.S. court has considered the legality of TPF in the context of commercial

[94] GARBER, *supra* note 7, at 13.
[95] *Id.* at 23.
[96] *Id.* at 13.
[97] *Id.* at 15.
[98] *Id.*
[99] *Id.*
[100] *Id.*
[101] *See* Jason Lyon, *Revolution in Progress: Third-Party Funding of American Litigation*, 58 UCLA L. REV. 571, 575 (2010).
[102] 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 (LexisNexis 2010); Ohio Non-Recourse Civil Litigation Advances, OHIO REV. CODE ANN. § 1349.55 (West 2008).

litigation.[103] With respect to loan agreements in personal injury suits, the case law is mixed. Many courts have held these agreements to be valid and enforceable.[104] Other courts, however, have invalidated these agreements.[105] The most frequently cited criticism is that loan agreements in personal injury suits 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.[106] Although there have been few prosecutions in the last century, the doctrines are still considered valid in the U.S. By contrast, in Australia, some states have abolished these doctrines (e.g., Victoria, New South Wales, Australian Capital Territory, and South Australia).[107]

II. POTENTIAL REASONS FOR A LOW LEI FREQUENCY AND LEI'S INFLUENCE ON TPF

The data in section I demonstrate that the frequency of purchasing legal expenses insurance is relatively low in many countries. This section, examines several potential explanations for this phenomenon. It discusses the plausibility of each explanation, and where available, uses empirical research in support. It then analyzes whether these explanations may influence the development of TPF.

A. The existence of alternatives for access to justice

[103] *See* Lyon, *supra* note 97, at 575.

[104] *See, e.g.*, Saladini v. Righellis, 687 N.E.2d 1224 (Mass. 1997); Osprey, Inc. v. Cabana Ltd. P'ship, 532 S.E.2d 269 (S.C. 2000).

[105] *See* Rancman v. Interim Settlement Funding Corp., 789 N.E.2d 217, 219-221 (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, LLC, 665 S.E.2d 767 (N.C. Ct. App. 2008).

[106] The U.S, 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).

[107] *See* DANIEL L. CHEN & DAVID S. ABRAMS, A MARKET FOR JUSTICE: THE EFFECT OF THIRD PARTY LITIGATION FUNDING ON LEGAL OUTCOMES, at 9-11 (2011), *available at* http://www.duke.edu/~dlc28/papers/MktJustice.pdf.

1. LEI

A first potential explanation relates to alternative methods for settling disputes. In some legal systems, risk-averse individuals may use a results-based compensation system to pay their lawyers. In the U.S., for example, the vast majority of individual plaintiff's attorneys bring cases on a contingency fee basis in tort litigation.[108] In 1995, the United Kingdom instituted a variant of a contingent fee system known as 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.[109] Demand for LEI may be lower in legal systems where individuals can reduce the risk of a trial via result-based compensation systems.

Additionally, demand for LEI should be lower if victims, *ex ante*, know that the state will cover at least some part of their trial costs. Demand for LEI may be even lower in systems that provide legal aid. Further, it is possible that when a state reduces the financing of its legal aid scheme, demand for LEI will subsequently increase. Simple economics dictates this result. If potential victims can rely on state aid that would, hypothetically, provide the same quality of services provided via LEI, relying on publicly-provided legal aid is the cheapest option, as there is no premium to be paid. In that sense, state-provided legal aid creates a moral hazard problem because victims can free ride on the state. A similar argument has been made with respect to disaster insurance.[110] Some scholars claim that the low demand for this type of insurance is

[108] A U.S. survey by Kakalik and Pace (1986) showed that 96% of individual plaintiff's attorneys in tort litigation brought cases on a contingency fee basis, while 95%of defendants' attorneys worked for an hourly wage. *See* JAMES S. KAKALIK & NICHOLAS M. PACE, COSTS AND COMPENSATION PAID IN TORT LITIGATION, at 96-97 (1986).

[109] *See* Daniel L. Rubinfeld and Suzanne Scotchmer, *Contingent fees*, *in* THE NEW PALGRAVE DICTIONARY OF LAW AND ECONOMICS 415-19 (Peter Newman ed., 1998).

[110] *See* Louis Kaplow, *Incentives and Government Relief for Risk*, 4 J. RISK & UNCERTAINTY 167 (1991) (arguing that government relief is inefficient due to problems of moral hazard).

related to the state's generous *ex post* relief following an accident.[111] Potential victims would free ride on the state rather than pay a premium.[112]

Empirical research supports many of these theoretical findings. For example, a recent study from the Netherlands states that the growth of LEI between 1970 and 2009 parallels regular cuts in legal aid and increases in private contributions.[113] However, the availability of public legal aid or results-based compensation systems cannot fully explain the low frequency of LEI in some countries. Even though contingency fees may be useful in many instances, they do not help those who have suffered relatively small losses and plaintiffs in non-monetary disputes. In the United Kingdom, not all cases can be financed under a Conditional Fee Arrangement and therefore citizens may demand LEI.[114] There are also countries where the people cannot afford legal costs, only a fraction are eligible for free legal aid, and no-cure, no-pay, and *quota pars litis* are prohibited, but yet LEI is not widespread. In 2003, 75% of the Belgian population claimed that the costs of a legal proceeding were too high (of the 25% who could afford litigation, 10% had independent financing and 15% qualified for legal aid).[115] 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. However, this is not the case.

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[111] In the literature this is referred to as the "Charity Hazard". Paul A. Raschky, P. & Hannelore Weck-Hannemann, *Charity Hazard – A Real Hazard to Natural Disaster Insurance?*, 7 ENVTL. HAZARD 321, 321 (2007).

[112] *See* Richard Epstein, *Catastrophic Responses to Catastrophic Risks*, 12 J. RISK & UNCERTAINTY 287, 293-95 (1996).

[113] Carolien Klein Haarhuis & Ben van Velthoven, *Legal Aid and Legal Expenses Insurance, Complements or Substitutes? The Case of the Netherlands*, LEIDEN LAW SCHOOL, DEP'T OF ECON., 3, (Feb. 2010), http://media.leidenuniv.nl/legacy/bvv-2010-02.pdfhttp://media.leidenuniv.nl/legacy/bvv-2010-02.pdf.

[114] *See* Michael G. Faure, Fokke J. Fernhout & Niels J. Philipsen, *Resultaatgerelateerde Beloningssystemen voor Advocaten*, METRO, UNIVERSITEIT MAASTRICHT, 59, (June 12, 2006), http://wodc.nl/onderzoeksdatabase/internationale-vergelijking-beloningssystemen-advocatuur.aspxhttp://wodc.nl/onderzoeksdatabase/internationale-vergelijking-beloningssystemen-advocatuur.aspx.

[115] Report of the working group "Rechten van Slachtoffers" (Rights of Victims), Parliamentary proceedings of the Belgian Senate 2002-2003, at 2, March 13, 2003, 2-1275/1.

2. TPF

There are parallels between the demand for LEI and the demand for TPF. As with LEI, the demand for TPF can largely be explained by the availability of alternatives. In jurisdictions where publicly-provided legal aid is generous, which could cause a moral hazard or "charity hazard," problem the demand for TPF will likely be relatively small. Litigants will not demand TPF if they can free ride on state provided legal aid. To the contrary, demand for TPF will likely increase where alternative funding systems are unavailable or inadequate. However, even if a country allows contingency fees, TPF may still have a future. Contingency fees are limited in several ways.[116] Contingency fees help plaintiffs transfer some litigation risk to their lawyers.[117] But there are investment cases that plaintiffs' lawyers are not eager to take. TPF funding may persuade risk-averse lawyers to take these cases. Also, lawyers cannot pay cash for a fraction of their clients' claims.[118] They can only advance out-of-pocket litigation expenses under contingency fees. Additionally, contingency fee "lawyers can only pay with their services."[119] This limits the fraction of a claim that a lawyer can purchase.[120] When lawyers are the sole source of capital, its amount and timing is quite limited. This reduces competition for capital-constrained clients, which leads to higher costs for these clients. As Chen and Abrams (2011) put it, "[b]y opening up provision of capital to the market, third party litigation funding solves a number of shortcomings this [sic] whereas contingency fees do not."[121]

Another question is to what extent the existence of LEI could hinder the development of TPF. As previously seen, in some countries a large fraction of the population is covered by LEI, generally after government intervention. LEI is becoming more popular in other countries and

[116] *See* Chen & Abrams, *supra* note 103, at 7-8.
[117] *Id.*
[118] *Id.* at 8.
[119] *Id.*
[120] Usually between 1/3 and ½ of the plaintiff's recoveries.
[121] Chen & Abrams, *supra* note 103, at 9.

several countries, such as the UK, are working to promote LEI to more people. Widespread LEI will substantially diminish the demand in the segment of consumer legal funding. In other segments (loans to plaintiffs' law firms and investments in commercial claims), however, LEI cannot compete with TPF. Because of moral hazard and adverse selection problems, LEI often provides relatively low upper limits on the maximum amount of coverage. Moreover, TPF does not promote access to justice as much as it serves as a financing and funding instrument. Therefore, even under a contingency fee arrangement, which stimulates access to justice, TPF may still be an attractive instrument to obtain upfront funding for some plaintiffs.

B. Adverse Selection

1. LEI

The problem of adverse selection may play a role in the case of LEI. Some individuals may be more likely to file a lawsuit than others. If an insurer cannot distinguish between these two groups, he is forced to average premiums between all of them. Consequently, legal expenses insurance may be particularly attractive for high-risk individuals.[122] As a result, those taking out LEI are more likely to be litigious, thereby increasing LEI premiums. This may result in only the most litigious individuals being interested in taking out LEI. Ultimately, this could lead to particular risks being uninsurable.[123] Adverse selection problems are likely more substantial for stand-alone LEI products than for add-on legal expenses insurance since for the latter, LEI

[122] *See* George Akerlof, *The Market for "Lemons": Quality, Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488, 492-94 (1970); *see also* George Priest, *The Current Insurance Crises and Modern Tort Law*, 96 YALE L. J. 1521, 1541 (1987).
[123] *See id.*

policies are added to other types of insurance, which usually have well-balanced risk pools.[124] However, the market for these add-on policies is thin in many countries.

Nevertheless, theoretical insurance literature indicates that problems of adverse selection can be mitigated in several ways: the exclusion of certain risks from insurance,[125] risk-based diversification of premiums,[126] ceilings on the amount of coverage per period, and offering a variety of insurance policies with different combinations of coverage and premiums.[127] Also, recent empirical research shows that adverse selection may depend heavily upon the type of insurance market and may not be as serious a problem in many insurance markets, contrary to suggestions in the literature.[128]

Recent empirical research from the Netherlands indicates that there is apparently not an adverse selection problem in the market for legal expenses insurance.[129] This research uses data gathered in a 2009 "Paths to Justice" survey. The survey investigated the potential for sixty-seven different civil and administrative lawsuits, and other similar lawsuits, in the Netherlands from 2004 to 2008 The survey sample was representative of 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. Nearly 61% of the respondents faced one or

[124] *See* Kilian & Regan, *supra* note 67, at 240-41; Barzel shows that insurance packages that tie substitutes and exclude 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* Yoram Barzel, *Competitive Tying Arrangements: The Case of Medical Insurance*, 19 ECON. INQUIRY 598 (1981).

[125] Kilian, *supra* note 5, at 39.

[126] Whenever possible, insurers should differentiate between high and low risk individuals. If high risk individuals (e.g., those who are very litigious) can be charged higher premiums, the unraveling of risk pools (typical for adverse selection) can be prevented.

[127] This may induce policyholders to reveal their type. *See* Winand Emons, *The Theory of Warranty Contracts*, 3 J. ECON. SURVEYS 43, 50-52 (1989).

[128] *See* Willem van Boom, *Insurance Law and Economics: an Empirical Perspective, in* ESSAYS IN THE LAW AND ECONOMICS OF REGULATION, IN HONOUR OF ANTHONY OGUS, at 256-259 (Michael G. Faure and Frank Stephen eds., 2008).

[129] *See* Klein Haarhuis & van Velthoven, *supra* note 110, at 5-6.

Met opmaak: Engels (V.S.)

more non-trivial[130] justiciable problem. The average number of potential lawsuits for all respondents was 1.88. The problem frequency of individuals with LEI, at 1.97, was 11% higher than for individuals without LEI, who faced 1.78 problems. The researchers recognized that this difference could be explained by a selection effect and a behavioral effect (moral hazard, see also further at C. When controlling for several personal characteristics, such as age, marital status, education and social group, the researchers found that LEI holdership increased the frequency of justiciable problems by 8%. In other words, there was a selection effect of 3% and a behavioral effect of 8%. In sum, it is unlikely that adverse selection can explain the relatively small size of LEI markets.

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 little or no recovery outside of their non-recourse loan envisage lower costs to promising to pay out of their proceeds. Because individual transactions are fairly small in this segment, TPF suppliers will not be willing to spend a lot on due diligence costs, or evaluating the prospects for repayment. This relates to the general notion that adverse selection stems from information asymmetry between the individual covered by TPF and the funding agent. The individual may have better information on his case's quality 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, because an individual risk assessment is too costly, TPF agents will, just like insurers, classify risks and try to remedy adverse selection through risk classification. Nevertheless, there is a positive side. Given the relatively small amount of funding per

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

transaction in consumer loans, well-capitalized suppliers can have many concurrently outstanding loans and therefore keep portfolio risks 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 considering 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 lawyers screen cases. Helland and Tabarrok's (2003) research finds that legal systems which support contingency fees increase legal quality and decrease the time to settlement.[131] This is consistent with Dana and Spier's (1993) theoretical model, which demonstrates that contingency fees decrease frivolous lawsuits.[132] Fenn and Rickman (2010) summarize empirical studies of contingency fee arrangements and find that lawyers who use no-win, no-fee arrangements screen their cases more and settle sooner.[133] 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 be especially true for large stakes claims. With respect to plaintiffs' law firms loans, firms nearer to financial collapse are more likely to ask for a loan simply because they have little to lose. TPF suppliers may be willing to spend more on evaluating the prospects for repayment than they would in consumer legal funding since loans are larger on average. Finally, in commercial litigation investments, owners of commercial claims are more likely to share the financial upside of their claims when they are

[131] Eric Helland & Alexander Tabarrok, *Contingency Fees, Settlement Delay and Low-Quality Litigation: Empirical Evidence from Two Datasets*, 19 J.L. ECON. & ORG. 517 (2003). The authors use a cross-section of states and a time series of medical malpractice claims in Florida.

[132] James D. Dana & Kathryn E. Spier, *Expertise and Contingency Fees: The Role of Asymmetric Information in Attorney Compensation*, 9 J.L. ECON & ORG. 349 (1993).

[133] Paul Fenn & Neil Rickman, *The Empirical Analysis of Litigation Funding*, *in* NEW TRENDS IN FINANCING CIVIL LITIGATION IN EUROPE 131, 145 (Mark Tuil & Louis Visscher eds., 2010).

less optimistic about the probability of winning the claim and subsequent damages. However, in commercial litigation, TPF suppliers may be willing to invest more to evaluate the quality of the claim, given the larger amounts at stake.

C. Moral Hazard

1. LEI

In the presence of asymmetric information, LEI markets may also suffer from moral hazard problems.[134] Moral hazard is a fully insured individual's tendency to exercise less care in protecting themselves against loss. It is a form of *ex post* opportunism, which occurs when the insurer cannot observe the actions of the insured. In such a case, the insurer is unable to link premiums to an insured's actions. The insured will reduce his level of care, thereby increasing insurance premiums. The increase may be so large that individuals facing the risk choose to increase their private level of care rather than buy insurance. The moral hazard problem, therefore, could cause a breakdown of the insurance market.

In the context of LEI, we can distinguish between several variants of moral hazard. Initially, 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 for the reputation for default of a future contract party. Individuals with LEI may also be more likely to bring existing problems to a head.[135] Next, an insured person may be less hesitant to initiate legal proceedings than an uninsured person, even with a weak claim.[136] Also, a policyholder may want to pursue a claim

[134] On moral hazard and insurance, *see* Steven Shavell, *On Moral Hazard and Insurance*, 93 Q. J. ECON. 541 (1979).
[135] *See* Klein Haarhuis & van Velthoven, *supra* note 110, at 7.
[136] BEN VAN VELTHOVEN & MARIJKE TER VOERT, GESCHILBESLECHTINGSDELTA 2003, 151 (2003).

Met opmaak: Engels (V.S.)

more intensely than a person without LEI.[137] He may want his insurer or lawyer to spend more time on the case than it is worth. 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 an insurance company's deep pockets, a lawyer may feel less restricted to behave opportunistically.

As indicated above, there are several standard responses for moral hazard problems that can also be helpful in the context of LEI.[138] Mechanisms can be introduced in an insured's policy that gives the insurer some control on whether to file a lawsuit or limit the free choice of an attorney, if legally permissible.[139] In the latter case, the insurer has the advantage of limiting the choice of attorneys to the insured, thereby allowing the insurer to make *ex ante* fees agreements. Also, the insurer can design contractual limitations that have the effect of risk sharing between insurer and insured, including deductibles, minimum claim levels, co-insurance, etc.[140] 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 more prevalent in legal systems where hourly fees can be charged and fees are unregulated.[141] Hence, it can be predicted that if legal systems regulate attorney's fees, this could increase the *ex ante* possibilities of adequate risk calculation for the insurer. Thus, one could predict LEI to be more prevalent in legal systems where attorney's fees are regulated or other mechanisms exist whereby the insurer can control for moral hazard of the insured and attorneys (see section 2.1.3 for the case of Germany). This may well explain the success of LEI in Denmark; because attorney's fees are in principle limited to the amount the insured would receive under legal aid, moral hazard can be effectively controlled.

[137] Roger Bowles & Neil Rickman, *Asymmetric Information, Moral Hazard and the Insurance of Legal Expenses*, 23 GENEVA PAPERS ON RISK AND INS. 196, 197 (1998).

[138] For a summary of the literature on moral hazard, see van Boom, *supra* note 103, at 253-76.

[139] As we already mentioned 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.

[140] *See* Kilian, *supra* note 5, at 39.

[141] For a summary of the literature, see Frank H. Stephen & James H. Love, *Regulation of the Legal Profession*, *in* ENCYCLOPEDIA OF LAW AND ECONOMICS, 987-1017 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000).

Empirical research from the Netherlands shows that the moral hazard problem is relatively small in the context of LEI.[142] LEI holdership increases problem frequency by 8% (see also at 3.6.1). German research shows that LEI does not automatically lead to an explosion in litigation. Insured plaintiffs litigate only 5%–10% more often than uninsured plaintiffs.[143] As a result, it seems unlikely that moral hazard can explain the low frequency of LEI in certain places.

2. TPF

Moral hazard problems can also be present in the market for TPF. In the context of consumer legal funding, as soon as a consumer's prospect of having money left after paying 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, although not insurmountable, under TPF. The TPF contract can, for example, 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 the decision maker (the TPF receiver or supplier) to account for both entities' costs and benefits, rather than only its own. As long as the decision maker bears an equal share of the costs and benefits of each additional investment in the case, he can be expected to behave in an optimal way from the point of view of both the TPF receiver and supplier. Under such a scheme, the decision maker's marginal costs equal his marginal benefits at the same point where total marginal costs equal total marginal benefits.[144] However, such incentive schemes are not

[142] *See* Klein Haarhuis & van Velthoven, *supra* note 110, at 7-8.

[143] *See* ERHARD BLANKENBURG & JANN FIEDLER, DIE RECHTUSSCHUTVERSICHERUNGEN UND SEIGENDE GESCHAFTSANFALL DER GERICHTE (1981).

[144] For such a scheme in the context of contingency fees, see A. Mitchell Polinsky and Daniel L. Rubinfeld, *Aligning the Interests of Lawyers and Clients*, 5 AM. L. & ECON. REV. 165 (2003).

observed in the three different segments of TPF, so some moral hazard problems should be expected.

One may fear that TPF of mass consumer claims may increase 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 these suits.[145] The main reason is that class actions magnify the stakes and complexity of an action. This compounds the defendant's litigation, reputation, and risk-bearing costs. Several reform proposals have been advanced: strengthening sanctions for frivolous filings, shifting some portion of the winner's attorney's fee to the losing side,[146] having the trial judge conduct a preliminary merits review at the certification stage,[147] and having the judge hold multiple class trials and base his or her judgment on a weighted combination of the several verdicts.[148]

D. Positive externalities/the free rider problem

1. LEI

Recently, another reason for a market failure in LEI has been advanced.[149] 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 is stolen, only the owner will benefit from the theft insurance. Legal

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

[146] *See* 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 (2001).

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

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

[149] *See* Jef De Mot & Michael G. Faure, *Legal Expenses Insurance and the Free Rider Problem* (Working Paper, 2011), *available at:* https://biblio.ugent.be/input/download?func=downloadFile&fileOId=1071903&recordOId=1070897.https://biblio.ugent.be/input/download?func=downloadFile&fileOId=1071903&recordOId=1070897.

expenses insurance, however, may create positive externalities. A potential victim with LEI may be able to bring a case to court that he would not otherwise have brought because of risk-aversion or lack of funds. When more individuals take LEI, the probability that an injurer will avoid consequences 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 thereby benefit from others' decisions 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 between parties with and without an insurance policy (as is generally the case for torts).[150] Furthermore, the free rider problem can expected to be most prevalent in cases in which first-party damage insurance is available. If first-party damage insurance is unavailable or only partially available, 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. For example, if an insurance company has a market share of 10% in the LEI market, then 90% of the deterrence benefits of each LEI policy will go to other insurance companies. This could lead to a free rider problem that prevents the insurance industry from taking meaningful action.[151] This could explain why there are so few companies that offer very comprehensive policies.[152] A similar argument has been made with respect to Lojack.[153] The

[150] 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.

[151] Especially for negative expected value claims.These are claims for which the expected benefits are smaller than the expected costs. Note that also strong claims can have negative expected value.

[152] *See* McDonald et al., *supra* note 9, at 52.

question why most auto insurance companies give no discount for Lojack has been answered from two different perspectives.[154] According to one view, Lojack is not a winner for insurers with a relatively low market share, as most of the benefit will go to their rivals.[155] According to another view, Lojack is probably not very effective. If it were, the free rider problem could be easily solved. If car manufacturers would install Lojack on their cars, thieves would stay away from these cars, and the manufacturers would reap the benefits.[156] Even if this argument is correct, it would be hard to find an analogous market solution in the context of LEI for torts.

2. TPF

The previous section has shown that there can be a problem of positive externalities stemming from potential victims' decisions on whether or not to take LEI. In the context of TPF, individuals deciding whether to use TPF will also not take the positive externalities of their decisions into account. This is a straightforward application of Shavell's theory (1982).[157] When a victim has suffered harm, he does not take the general deterrent effect of his lawsuit into account, as filing a lawsuit cannot change the injurer's behavior. The victim only looks at the damages he could be awarded. The previous section has also demonstrated that the presence of positive externalities may lead legal expenses insurers not to offer comprehensive LEI. In the context of TPF, however, there may be a different problem. If a TPF supplier provides

[153] 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 activate the transmitter and specially equipped police cars and helicopters track the precise location and movement of the vehicle.

[154] In some states, discounts are mandated (e.g. Florida, New York, New Jersey, Pennsylvania). See JOHN R. LOTT, FREEDOMNOMICS: WHY THE FREE MARKET WORKS AND OTHER HALF-BAKED THEORIES DON'T 204, note 52 (2007).

[155] Ian Ayres & Barry Nalebuff, *Stop, Thief!*, FORBES (Jan. 10, 2005), http://www.forbes.com/forbes/2005/0110/088_print.html.

[156] When the rate of theft of a car model decreases, the car model becomes more attractive to consumers by lowering insurance premiums. *See* JOHN R. LOTT, FREEDOMNOMICS: WHY THE FREE MARKET WORKS AND OTHER HALF-BAKED THEORIES DON'T 43-44 (2007).

[157] Steven Shavell, *The Social Versus the Private Incentive to Bring Suit in a Costly Legal System*, 11 J. LEGAL STUD. 333 (1982).

substantial funds for a specific type of claim, this may increase deterrence for these claims. Consequently, there will be fewer of these cases in the future, which reduces the future profits of the TPF industry in this particular segment. The company that provides funds for these claims only suffers part of the harm and the rest is externalized; other companies' future profits decrease as well. From the TPF industry's perspective, 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? In such a scenario, funds may not go to the claims that, from a social perspective, are the most deserving of funding—the cases that can be easily deterred. It is unlikely that the TPF industry has an interest in substantially decreasing the accident rate, as the need for TPF decreases when more accidents are deterred. A monopolistic TPF industry will provide funding until its marginal benefit equals its marginal cost. That industry will prefer to divert funds to cases that are difficult to deter because those will not affect the industry's future income stream.

A parallel can be drawn here to the insurance industry's incentives to reduce the accident rate. In the insurance literature, there is a striking diversity in viewpoints with respect to the industry's interest in accident reduction.[158] According to one view, the insurance industry has a positive interest in accident reduction.[159] Another view states that the industry is simply not

[158] *See generally* GERALD J.S. WILDE, TARGET RISK (1994).

[159] As one commentator puts it: "[I]t is obviously of great interest for the insurance companies . . . to reduce the number of traffic accidents and consequently their cost." Tore Vaaje, *Rewarding in Insurance: Return of Part of Premium After a Claim-Free Period*, 1990 PROCEEDINGS, OECD/ECMT SYMPOSIUM ON ENFORCEMENT AND REWARDING: STRATEGIES AND EFFECTS.

interested in accident reduction.[160] A third view holds that the industry's interest is served if the accident rate is at a high level[161] Note that insurers may have an interest in a high accident rate under some types of premium regulation. 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 can write."[162] Note that this problem may also arise in the context of LEI. Offering comprehensive LEI policies could also reduce the accident rate for some types of claims. Whether this problem is substantial for LEI will depend on (1) the relationship between profit per insurance contract and the types and frequency of accidents and (2) whether LEI insurers and liability insurers or damage insurers are integrated. It is worth recognizing that the additional premium income from LEI would partially offset the losses in premium income for other insurance policies.[163]

III. ADVANTAGES AND DISADVANTAGES OF TPF AND LEI

A. *The volume of litigation*

1. TPF

[160] "[I]nsurance . . . 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." Yvon Chich, *L'Assurance automobile peut-elle et veut-elle investir dans l'action préventive?*, *translated in* GERALD J.S. WILDE, TARGET RISK (1994), available at http://psyc.queensu.ca/target/chapter11.html.

[161] *See also* M. Gray, *Insurance Logic that is Blind to Safety Inventions*, LLOYD'S LIST (Nov. 2, 1989) ("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.").

[162] W. Kip Viscusi, *The Dimensions of the Product Liability Crisis*, 20 J. LEGAL STUD. 147, 148 (1991). However, Viscusi (2004) 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. W. Kip Viscusi, *Tort Reform and Insurance Markets*, 7 RISK MGMT. & INS. REV. 9, 17 (2004).

[163] 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 litigation due to the availability of TPF is a matter of simple economics.[164] For example, third-party financing may increase the amount and cost of litigation for business disputes. Without TPF, a business-plaintiff will compare the internal cost of capital with the expected return from filing a lawsuit. The case will be filed only if the expected return is large enough. If TPF is available at a lower expected cost than the internal cost of capital, then there may be more litigation by business-plaintiffs.[165] This cost-reducing effect of TPF may also increase the amount of litigation by reducing the settlement surplus. Indeed, when the plaintiff's or defendant's trial costs decrease, the settlement surplus decreases.[166] This generally leads to more trials, as one of the reasons that parties settle is to avoid the costs of trial. TPF can also increase the volume of litigation involving individuals as plaintiffs. In the U.S., these plaintiffs can often rely on contingency fees to finance litigation. This does not mean that TPF will not increase litigation in this segment, however. There are positive expected value cases that 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).[167] At the same time, limits on economies of scale make litigation in many very large cases infeasible. Here, third-party financing could fill a gap[168] because there are greater economies of scale in finance than in litigation.[169] A recent empirical study by Chen and Abrams[170] found that the number of suits increased in Australia after it allowed the free sale of lawsuits.

[164] *See* JOHN BEISNER, JESSICA MILLER & GARY RUBIN, U.S. CHAMBER INST. FOR LEGAL REFORM, SELLING LAWSUITS, BUYING TROUBLE: THIRD-PARTY LITIGATION FUNDING IN THE UNITED STATES 2-3 (2009).
[165] *See* Rubin, *supra* note 6, at 3-4.
[166] 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.
[167] The risk can be so large that losing such a case would lead to bankruptcy of the law firm.
[168] *See* Michael Abramowicz, *On the Alienability of Legal Claims*, 114 YALE L.J. 697, 739 (2005).
[169] *See* Rubin, *supra* note 6, at 6.
[170] *See* Chen & Abrams, *supra* note 83.

Others are more hesitant to draw such a general conclusion for various reasons.[171] First, the fact that TPF allows more individuals or organizations to bring claims that they otherwise would not bring or fight a claim more vigorously increases the deterrence of behavior that could lead to lawsuits. Consequently, the availability of funds to pursue litigation does not unambiguously increase litigation.[172] Second, because Abrams and Chen's statistical analyses rely on small sample sizes (five to seven observations), more empirical research is necessary. Third, the question of whether TPF will substantially increase the volume of litigation may vary by country, depending on the instruments currently available in that country to increase access to the courts. For example, the resulting increase in litigation in the U.S. could be modest if lawsuits are not currently filed not because of a lack of capital, but because of a lack of additional potential claims that contingency fee lawyers are willing to take.[173] In Europe, however, TPF's potential to increase litigation may be greater, as contingency fees are prohibited in many European countries, public support for legal aid is being reduced in some European countries, and LEI is not generally widespread.

As Garber (2010) points out, the conditions needed for TPF to increase litigation may strongly depend on the TPF segment involved.[174] Regarding loans to plaintiffs' law firms, an increase in the volume of litigation is to be expected if firms use the funds to take on more clients instead of smoothing their cash flow or working more on the cases that they have already

[171] *See* Garber, *supra* note 7, at 29.

[172] *See also* DAVID DANA & MAX SCHANZENBACH, NORTHWESTERN UNIV. LAW SCH., HOW WOULD THIRD PARTY FINANCING CHANGE THE FACE OF AMERICAN TORT LITIGATION? THE ROLE OF AGENCY COSTS IN THE ATTORNEY-CLIENT RELATIONSHIP (9 (2009), *available at* http://www.law.northwestern.edu/searlecenter/papers/Schanzenbach_Agency%20Costs.pdf (paper presented at Searle Public Policy Roundtable on Third Party Financing of Litigation, , Chicago, Ill. September 24–25, 2009).

[173] *See, e.g.*, Herbert M. Kritzer, *Contingency Fee Lawyers as Gatekeepers in the Civil Justice System*, 81 JUDICATURE 22 (1997) (showing that contingency fee lawyers only accept a small minority of cases).

[174] *See* Garber, *supra* note 7, at 29-30.

taken.[175] For investments in commercial claims, the number of claims may increase substantially where the economics of a claim look attractive to a TPF supplier, but companies are not able or willing to use internal capital to pay hourly legal expenses and cannot find a law firm to represent them on a contingency-fee basis. The strength of the effect in this segment is difficult to predict, as 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, it is unknown 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.

2. LEI

On a theoretical level, LEI 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, empirical research from Germany and the Netherlands has shown 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 the insurer pays a portion of the cost.[176] Note, however, that costs such as psychological costs and the opportunity cost of time are not externalized to the insurer. Third, LEI promotes the filing of suit by risk-averse plaintiffs, as they do not 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 of whether LEI holders react differently from non-insured individuals when

[175] Of course this will increase the costs of individual cases.

[176] *See, e.g.*, Roland Kirstein, *Risk Neutrality and Strategic Insurance*, 25 THE GENEVA PAPERS ON RISK & INS. 251, 260 (2000).

Met opmaak: Engels (V.S.)

faced with a justiciable problem.[177] Of all the individuals who faced a justiciable problem but did not have LEI, 7.5% did nothing, 47.4% sought to resolve the problem without help, and 45.1% sought 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% did nothing, 37.7% sought to resolve the problem without help, and 57.5% sought 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, as he does not bear all of the costs of a trial. Because the settlement surplus decreases, the frequency of trial can be expected to increase. However, this does not account for 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 the right to take all necessary steps to settle the case.[178] Because 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%) is perceived to be significantly larger than the settlement frequency of other claims seems to confirm this.[179] However, this result could also be the consequence of selection effects. According to the standard relative optimism model of litigation, the settlement frequency is larger for smaller claims,[180] and LEI can be expected to stimulate some of these smaller claims, as empirical research has shown that LEI promotes the settlement of some smaller cases.[181]

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[177] *See* Klein Haarhuis & van Velthoven, *supra* note 110, at 9.

[178] *See* PHILLIPE COLLE, HANDBOEK BIJZONDER GEREGLEMENTEERDE VERZEKERINGSCONTRACTEN 304 (2005).

[179] *Id.*

[180] *See, e.g.,* Steven Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis under Alternative Methods for the Allocation of Legal Costs*, 11 J. LEGAL STUD. 55, 59 (1982).

[181] *See* Vivian Prais, *Legal Expenses Insurance, in* REFORM OF CIVIL PROCEDURE: ESSAYS ON 'ACCESS TO JUSTICE' 439 (Adrian A.S. Zuckerman & Ross Cranston eds., 1995).

In countries like Germany, however, where lawyers enjoy monopoly rights not just for representation in court but also for out of court work, the insurer's role 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.[182] 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.[183] The difference is more substantial for higher income classes. Similar to the case of TPF, the presence of LEI may increase deterrence, which may have a mitigating effect on the volume of litigation. Hence, one should always be careful in interpreting these numbers: if the volume of cases increases under LEI, then from a social welfare perspective this is not always an undesirable effect. It might be undesirable if LEI claims are 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.

B. *The quality of litigation and the accuracy of settlements*

1. TPF

Some commentators expect that TPF will increase the number of lawsuits that have no or dubious legal merit.[184] The reason that this may be the case is because plaintiffs (and their lawyers) are more eager to bring such lawsuits if they are not fully financing the cases themselves. However, it is quite unlikely that consumer legal funding will substantially increase the volume of meritless cases. These loans are typically less than 10%of the estimated recoveries in the underlying lawsuits.[185] Concerning loans to plaintiffs' law firms, TPF suppliers do not want to lend to firms who hold many low-probability claims, as 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. For commercial claims, TPF suppliers share in the upside potential of the claim. Given that low-probability suits can have high expected profits, TPF suppliers may choose to invest in these cases.

[182] *See id.*
[183] *See* Klein Haarhuis & van Velthoven, *supra* note 110, at 12.
[184] *See e.g.*, BEISNER, MILLER & RUBIN, *supra* note 163.
[185] *See* Garber, *supra* note 7, at 30.

Some scholars, however, doubt that the effect on the volume of low-probability cases will be substantial.[186] 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."[187] Of course, things could change, but for now, large capital providers such as banks and insurance companies have stayed away because of the legal uncertainty that surrounds litigation funding.[188] If this 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. Some TPF suppliers that lack the skills to evaluate complex cases effectively could enter, which may lead to an increase in lawsuits that lack merit. In the long run, however, investing in meritless 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, as 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

[186] *See id.* at 32.
[187] *See* Jonathan D. Glater, *Investing in Lawsuits, for a Share of the Awards*, N.Y. TIMES, June 3, 2009, at B1.
[188] *See* Molot, *supra* note 92, at 32.

disparity between the parties' ability to cope with litigation risk is enormous.[189] Thus, settlements that reflect bargaining power more than legal merit can be expected. Third-party financing may promote more accurate settlements by leveling the playing field between plaintiffs and defendants.[190] 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, very high interest rates and the rapid accumulation of interest strips this mechanism of much of its value. Also, investment funds only invest in large commercial claims, not in smaller claims or personal injury claims held by individuals.

2. LEI

It is often alleged that LEI causes a flood of unmeritorious litigation.[191] 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, it is highly unlikely that an insurer will provide coverage for weak claims. Legal expenses insurers have a relatively strong incentive to carefully screen cases before granting coverage, as insurers bear all or most of the costs of a trial but reap no direct financial benefits.[192] In practice, legal expenses insurers weed out weak cases through various mechanisms. For example, most LEI policies include a deductible.[193] Of course, a deductible will not only filter out some weak cases, but will also hold back some strong cases with small stakes. Additionally, LEI policies often include a merits test. In the absence of such a clause in the contract, doctrines of contract law may allow an insurer to

[189] *See* Jonathan T. Molot, *Litigation Finance: A Market Solution to a Procedural Problem*, 99 GEO. L.J. 65, 85 (2010).
[190] *Id.*
[191] *See, e.g.*, Kilian, *supra* note 5, at 45.
[192] We can thus expect that legal expense insurers have a stronger incentive to screen cases than hourly fee lawyers and contingency fee lawyers.
[193] Kilian, *supra* note 5, at 46.

decline coverage for unreasonable and futile claims, or for claims that lack evidence.[194] A German research report shows that litigants with LEI won their cases slightly more often (3 %) than self-financing litigants who paid their lawyers a fixed fee at every stage of the litigation process.[195] This could be a reflection of more careful case screening. However, the result could also be explained by a selection effect, as LEI will induce the filing of some strong claims with stakes that are relatively small but still greater than the deductible.

C. *The timing of settlements*

1. TPF

TPF may increase a defendant's willingness to settle at an earlier stage for several reasons.[196] First, a defendant who knows that the plaintiff has TPF may realize that certain threats made during the negotiations are no longer credible, thereby decreasing the defendant's bargaining power. Also, a TPF supplier's willingness to fund a case may be seen by the defendant as a signal that the case is of relatively high quality. Empirical research by Fenn and Rickman has shown that high-quality cases settle earlier. The authors have found that the more the defendant thinks he is liable, the shorter the delay of settlement.[197] Likewise, they have found that cases in which the insurer believes its policyholder is fully responsible are associated with shorter delays of settlement.[198] Finally, their research has discovered 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.[199] Furthermore, the arrival of new information

[194] For example, the contractually implied obligation of good faith. *See* COLLE, *supra* note 178, at 305.
[195] *See* Prais, *supra* note 181, at 439.
[196] *See* Garber, *supra* note 7, at 32-34.
[197] Paul Fenn & Neil Rickman, *Delay and Settlement in Litigation*, 109 Econ. J. 476, 487 (1999).
[198] Paul Fenn & Neil Rickman, *Asymmetric Information and the Settlement of Insurance Claims*, 68 J. RISK & INS. 615, 627 (2001).
[199] Paul Fenn & Neil Rickman, *Legal Liability and the Timing of Settlement in Medical Malpractice* 21 (American Law & Economic Association Annual Meetings, Paper No. 44, 2005), *available at*

weakening a hospital's case speeds up the settlement process and leads to longer durations before a case is dropped. That signal may be especially relevant for investments in commercial claims because of the rigorousness of due diligence processes.[200]

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 the amount owed to the TPF supplier. During the period inbetween the initial and the later phases of the settlement process, consumer legal funding may promote earlier settlements 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.

2. LEI

An empirical study by Fenn et al. (2005) finds that claims funded by LEI in England and Wales settle faster than claims funded by other means.[201] This can be explained quite easily. Because the insurer internalizes the costs—either in whole or in large part—of the settlement, he has every incentive to settle early. This effect will be largest if the insurer is in charge of the settlement negotiations.[202][203] But 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. This is because 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.

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*http://law.bepress.com/cgi/viewcontent.cgi?article=1543&context=alea*http://law.bepress.com/cgi/viewcontent.cgi?article=1543&context=alea.

[200] See Garber, supra note 7, at 26.

[201] PAUL FENN ET AL., REPORT TO THE DEPARTMENT FOR CONSTITUTIONAL AFFAIRS, THE FUNDING OF PERSONAL INJURY LITIGATION: COMPARISONS OVER TIME AND ACROSS JURISDICTIONS 51 (2006), *available at* http://webarchive.nationalarchives.gov.uk/+/http://www.dca.gov.uk/research/2006/02_2006.pdf.

[202] In Belgium, for example, lawyers' monopoly rights only extend to representation in court. In the context of LEI, legal services are often provided by in-house salaried personnel.

[203] 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/EEC on the Coordination of Laws, Regulations and Administrative Provisions relating to Legal Expenses Insurance, official reporter 1987 O.J. (L 185) 77, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31987L0344:en:NOT

D. *The costs of (individual) disputes*

1. TPF

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.[204] Unfortunately, this is unknown.[205] Expenditures will generally increase when TPF is sought primarily to loosen cash constraints (this can be 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 expenditures depends to a large extent on the share of the recovery and the costs for the TPF supplier.

2. LEI

Obviously, LEI can be expected to increase the costs of individual disputes. A plaintiff without LEI has to pay for each additional hour his lawyer spends on the case, whereas a plaintiff with LEI can use LEI staff, or, if necessary, a lawyer at no or reduced cost. Recent Dutch empirical research confirms this, at least for the high-income class.[206] 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).[207] For lower income classes, the impact of LEI is mainly by substitution.[208] The direct assistance of LEI staff comes, to a large extent, in place of the subsidized lawyer.[209] The researchers are aware that other factors may have played a role in the use of legal advisers.[210] After controlling for other relevant factors like type of problem, gravity and complexity of the problem, expected revenue, and personal characteristics, multivariate analysis corroborates their findings.[211] As a person actively responds to a justiciable problem, LEI increases the chance that a person will seek more legal advice.[212] Income is an important

[204] It may also depend on whether TPF suppliers provide information that helps lawyers make a more productive use of time and money.
[205] *See* Garber, *supra* note 7, at 35.
[206] *See* Klein Haarhuis & van Velthoven, *supra* note 110, at 10.
[207] *Id.*.
[208] *Id.*
[209] *Id.*
[210] Id. at 11.
[211] *Id.*
[212] *Id.*

Met opmaak: Nederlands (België)

factor when people are not insured: the number of contacts with legal advisers decreases with income.[213] When individuals are insured, the effect of income is insignificant.[214]

CONCLUSION

It is unlikely that LEI is a substantial barrier to the development of TPF. The reason is simple: LEI is underused in the U.S. and many European countries. Only countries where LEI is mandatory (as an add-on to household insurance, like in Sweden) have wide coverage. Regarding the social welfare effects of both instruments, TPF does not necessarily do worse than LEI as far as 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, because they consider it contrary to public policy. However, given the low coverage of LEI and reduced legal aid in many European legal systems, TPF can effectively promote access to justice even though such a goal may not be its primary function. 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. Thus, TPF certainly merits further analysis and could serve important social goals by promoting access to justice and providing further deterrence, reducing accidents and personal injury.

[213] *Id.*
[214] *Id.*