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## ***Juxtaposing BTE and ATE***

### ***On the role of the European insurance industry in funding civil litigation***

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# Juxtaposing BTE and ATE – on the role of the European insurance industry in funding civil litigation

*Willem H. van Boom*

## **Abstract:**

One of the ways in which legal services are financed, and indeed shaped, is through private insurance arrangement. Two contrasting types of legal expenses insurance contracts (LEI) seem to dominate in Europe: before the event (BTE) and after the event (ATE) legal expenses insurance. Notwithstanding institutional differences between different legal systems, BTE and ATE insurance arrangements may be instrumental if government policy is geared towards strengthening a market-oriented system of financing access to justice for individuals and business. At the same time, emphasizing the role of a private industry as a keeper of the gates to justice raises issues of accountability and transparency, not readily reconcilable with demands of competition. Moreover, multiple actors (clients, lawyers, courts, insurers) are involved, causing behavioural dynamics which are not easily predicted or influenced.

Against this background, this paper looks into BTE and ATE arrangements by analysing the particularities of BTE and ATE arrangements currently available in some European jurisdictions and by painting a picture of their respective markets and legal contexts. This allows for some reflection on the performance of BTE and ATE providers as both financiers and keepers. Two issues emerge from the analysis that are worthy of some further reflection. Firstly, there is the problematic long-term sustainability of some ATE products. Secondly, the challenges faced by policymakers that would like to nudge consumers into voluntarily taking out BTE LEI.

## **Keywords:**

legal expenses insurance, conditional fee arrangement, after the event insurance

## **JEL Classifications:**

G22, K12, K41

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## 1 Financing litigation with insurance arrangements

Fenn c.s. rightly note that “the ways in which legal services are financed are fundamental to issues surrounding access to justice and the efficiency, quality and competitiveness of legal service delivery.”<sup>1</sup> One of the ways in which legal services are financed, and indeed shaped, is through private insurance arrangement. In fact, the European insurance industry is crucial in financing the positions of both claimants and defendants in civil litigation and in smoothening out their settlement negotiations. Therefore, the insurance industry can be considered as one of the keepers of the gates to justice for both claimants and defendants. How do insurers perform their part as keeper?

To begin with, we need to distinguish liability insurance from legal expenses insurance. *Liability insurance* contracts have a dual indemnity purpose, as they do not merely protect the policyholder against liability, but also contain elements of legal expenses insurance as far as defending against claims is concerned.<sup>2</sup> Consequently, liability insurance is pivotal in defending against tort claims as it indemnifies the insured in capacity of alleged tortfeasor for legal costs and expenses incurred in defending claims made against the insured. Moreover, if the claimant prevails in court, the liability insurance policy may also cover the defendant’s liability for the claimant’s legal costs. Obviously, the extent to which such costs are actually shifted from the prevailing claimant to the defendant and his liability insurer depends on the applicable rules of civil procedure (and the policy cover).

This paper does not focus on the role of liability insurers but rather on legal expenses insurers. In civil litigation, *legal expenses insurance* contracts (LEI)<sup>3</sup> may finance either side of the claim - although they incline towards the claiming rather than the defending side of the claim. Indeed, in some European countries LEI has matured into an extremely important branch of indemnity insurance offering a high level of service in kind, employing and educating professional panel lawyers or procuring contracts for legal services in bulk. By contrast, in other countries LEI has not (yet) gained much ground. Undeniably, institutional differences in markets for private insurance, lawyers and tax-funded legal aid are

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<sup>1</sup> P Fenn, A Gray and N Rickman, *The funding of personal injury litigation: comparisons over time and across jurisdictions* (Department for Constitutional Affairs, London 2006) 1.

<sup>2</sup> The LEI Directive (Directive 87/344/EEC of 22 June 1987 on the coordination of laws, regulations and administrative provisions relating to legal expenses insurance, OJ L 1987/185, p. 77) excludes the LEI-aspect of liability insurance (i.e., the activity pursued by the insurer providing civil liability cover for the purpose of defending or representing the insured person in any inquiry or proceedings if that activity is at the same time pursued in the insurer’s own interest under such cover, art. 2 (2) Dir.).

<sup>3</sup> BTE LEI can be loosely defined as an undertaking, against the payment of a premium, to bear the costs of legal proceedings and to provide other services directly linked to insurance cover. Cf. art. 2 Directive 87/344/EEC of 22 June 1987 on the coordination of laws, regulations and administrative provisions relating to legal expenses insurance, OJ L 1987/185, p. 77. Cf. art. 196 of the Solvency II Proposal (recent Commission Proposal for the overhaul of insurance directives (Solvency II), COM(2008) 119 final; EP resolution 22 April 2009. Note that the BTE element seems missing in this definition.

responsible for the differences in size and societal relevance of national LEI markets.<sup>4</sup> To name one of these differences: some countries are more reluctant than others to accept the concept of salaried in-house solicitors.<sup>5</sup> Institutional preconditions are also at the root of the advance in some countries of so-called *after the event legal expenses insurance* (ATE LEI). This type of insurance is exactly what the name denotes: an insurance policy concluded after a dispute has arisen and litigation seems unavoidable. Unsurprisingly, ATE differs in many ways from regular LEI (also referred to as *before the event* (BTE) LEI).

In this paper, I will look into BTE and ATE arrangements by painting a picture of their respective markets and legal contexts. This allows for some reflection on the performance of BTE and ATE providers as both financiers and keepers. Notwithstanding institutional differences between different legal systems, BTE and ATE insurance arrangements may be instrumental if government policy is geared towards strengthening a market-oriented system of financing access to justice for individuals and business. At the same time, emphasizing the role of a private industry as a keeper of the gates to justice raises issues of accountability and transparency, not readily reconcilable with demands of competition. Moreover, multiple actors, ranging from clients, lawyers, courts, insurers (and possibly claims-managing intermediaries) are involved, causing behavioural dynamics which are not easily predicted or influenced. Against this background, I set out to analyse the particularities of BTE and ATE arrangements currently available in some European jurisdictions. By no means is this an exhaustive analysis as this paper merely concerns itself with some of the issues of insurer involvement in financing civil litigation.

## 2 Before The Event Legal Expenses Insurance (BTE LEI)

### 2.1 Market features

The role and relevance of BTE LEI varies among European countries. In Germany, BTE LEI is pervasive. The penetration rate of general household BTE LEI in Germany is some 50 percent.<sup>6</sup> By contrast, in England and Wales the demand for this type of BTE seems to be virtually absent. In yet other markets there is a trend towards multiple markets for BTE in

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<sup>4</sup> See, eg, R Kirstein and N Rickman, 'Third Party Contingency contracts in settlement and litigation' (2002) German Working Papers in Law and Economics 1 ff.

<sup>5</sup> Cf. T Schepens, 'Bridging the funding gap - The economics of cost shifting, fee arrangements and legal expenses insurance and their prospects for improving the access to civil justice' (2007) German Working Papers in Law and Economics 33.

<sup>6</sup> J Veith and J Gräfe (eds), *Der Versicherungsprozess* (Beck, München 2005) 978; J Werner, *Die Rechtsschutzversicherung in Europa - Eine Studie über die geschichtliche und wirtschaftliche Entwicklung sowie über die Versicherungsbedingungen der Rechtsschutzversicherungen in Europa* (VfW, Karlsruhe 1985) 94-96; J Flood and A Whyte, 'What's Wrong With Legal Aid? Lessons From Outside The UK' (2006) 25 *Civil Justice Quarterly* 92; M Kilian, 'Alternatives to Public Provision: The Role of Legal Expenses Insurance in Broadening Access to Justice: The German Experience' (2003) 30 *Journal of Law and Society* 34; M Faure, T Hartlief and N Philipsen, *Resultaatgerelateerde beloningssystemen voor advocaten - Een vergelijkende beschrijving van beloningssystemen voor advocaten in een aantal landen van de Europese Unie en Hong Kong* (WODC rapport) (Wetenschappelijk Onderzoeks- en Documentatiecentrum Ministerie van Justitie, Den Haag 2006) 55; R Jackson, *Review of Civil Litigation Costs - Preliminary Report* (London 2009) 564.

which both middle-class households and SMEs display an increasing demand for BTE products.<sup>7</sup>

Whether and how the BTE LEI markets in Europe will develop, depends on domestic institutional factors such as the extent of tax-funded legal aid and the intensity of regulation of legal services. For instance, one would expect a BTE market not to flourish in a country with comprehensive state-funded legal aid. And indeed, England and Wales spend a lot of taxpayers' money on legal aid<sup>8</sup> while German consumers spend less on taxation for legal aid but all the more on private BTE LEI.<sup>9</sup> Paradoxically, the UK private insurance market is the largest in Europe, but is clearly surpassed by Germany with regard to LEI.<sup>10</sup>

In some countries, BTE LEI has penetrated the consumer market preponderantly in the form of *add-on insurance*. In England and Wales, for instance, LEI is sold in a variety of ways (stand-alone, add-on) and through multiple channels.<sup>11</sup> Unsurprisingly, cover provided by add-on LEI is fragmented, and sometimes duplicated.<sup>12</sup> In fact, holders of certain policies (e.g., household insurance) may not even be aware that their insurance also covers certain legal expenses.<sup>13</sup> At first sight, the LEI coverage offered by household insurance (home insurance) and car insurance in England and Wales seems rather comprehensive as it covers claims for personal injury, (most) employment and consumer disputes. On the other hand, the policy limits are not always very high (e.g., GBP 15,000-25,000). The penetration rate of comprehensive stand-alone covers remains low.<sup>14</sup>

One of the institutional settings that seem to be relevant in explaining differences in development of BTE markets pertains to the rules on cost shifting in civil procedure. Like providers of any type of insurance, BTE providers prefer *predictability*. Therefore, BTE LEI is more likely to thrive under cost regimes that generate a certain level of predictability.<sup>15</sup> For

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<sup>7</sup> In The Netherlands, BTE LEI consists of two distinct markets, one for businesses (mainly SMEs) and one for households and traffic accidents. The number of BTE LEI policies taken out by SMEs in The Netherlands has almost doubled between 2000 and 2005 (meanwhile halving claim frequency). Generally, penetration of BTE LEI has increased from 14% in 2000 to 19% in 2004. See GC Maas, 'Kosten en financiering van rechtsbijstand' in JGv Erp and others (eds), *Geschiedprocedures en rechtspraak in cijfers 2005 Cahiers 2007/8* (Wetenschappelijk Onderzoek- en Documentatiecentrum Ministerie van Justitie, Den Haag 2007) 127 ff.

<sup>8</sup> In spite of the mid-1990s cut in expenditure (notably in civil cases) the overall legal aid bill for England and Wales remains one of the highest. See J Storer 'Legal aid bill "highest in world"' *BBC News* (London 24 September 2007) <[http://news.bbc.co.uk/go/pr/fr/-/2/hi/uk\\_news/politics/7009686.stm](http://news.bbc.co.uk/go/pr/fr/-/2/hi/uk_news/politics/7009686.stm)> accessed September 2009.

<sup>9</sup> See, eg, statistics on LEI premiums at [www.cea.eu/statistics](http://www.cea.eu/statistics). Cf. Flood and Whyte (n 6) 83 ff.; Kilian (n 6) 38 ff.

<sup>10</sup> Kilian (n 6) 41; N Rickman and A Gray, 'The Role of Legal Expenses Insurance in Securing Access to the Market for Legal Services' in AAS Zuckerman and R Cranston (eds), *The Reform of Civil Procedure: Essays on 'Access to Justice'* (Oxford University Press, Oxford 1996) 312 ff.

<sup>11</sup> Jackson (n 6) 151-153. For a sketch of the BTE market in England and Wales, see V Prais, 'Legal Expenses Insurance' in AAS Zuckerman and R Cranston (eds), *The Reform of Civil Procedure: Essays on 'Access to Justice'* (Oxford University Press, Oxford 1996) 433 ff.; Rickman and Gray (n 10) 312 ff.; N Rickman and P Fenn, 'Insuring Litigation Risk: Some Recent Developments in England and Wales' (1998) 23 *Geneva Papers on Risk & Insurance - Issues & Practice* 217 ff.; Jackson (n 6) 151 ff.

<sup>12</sup> O McDonald, I Winters and M Harmer, *The Market for 'BTE' Legal Expenses Insurance* (FWD thinking communications, London 2007) 17.

<sup>13</sup> Ibid. 53; Kilian (n 6) 39.

<sup>14</sup> Jackson (n 6) 151 f.

<sup>15</sup> G Dannemann, 'Access to Justice: an Anglo-German Comparison' (1996) 2 *European Public Law* 282 ff.; Prais (n 11) 440; Rickman and Gray (n 10) 320; A Walters and J Peysner, 'Event-triggered financing of civil claims: lawyers,

instance, the German and Dutch costs rules (i.e., the loser pays according to fixed scales) are more beneficial to BTE LEI insurers looking for predictability than the current English cost shifting rules.<sup>16</sup> Moreover, BTE insurers have every incentive to fix and control lawyers' remuneration and possibly even to employ in-house lawyers in order to accurately calculate (and cut) premiums.<sup>17</sup>

Apart from institutional factors, which go a long way in explaining the development of the various markets, cultural factors such as the level of litigiousness may be relevant as well.<sup>18</sup> It is sometimes said that Germans are more litigious by nature than, e.g., the English.<sup>19</sup> Whether this is true seems hard to verify – indeed, one may well conjecture that the level of litigiousness is dependent to some extent on the costs of getting access to justice, subjecting all cultures to seemingly universal laws of susceptibility to financial restraints.

## 2.2 Legal context: the LEI Directive

At European level, LEI is regulated to some extent under Directive 87/344 on the coordination of laws, regulations and administrative provisions relating to legal expenses insurance.<sup>20</sup> The provisions of the LEI Directive are to be copied into the Solvability II Directive. No major overhaul of the regulatory framework for LEI is foreseen.

Three features of the LEI Directive are worth mentioning. Firstly, the Directive aims at neutralizing potential conflicts of interest between insured and insurer. Any conflicts of interest arising, in particular from the fact that the insurance undertaking is covering another person or is covering a person in respect of both legal expenses and any other class of insurance should be precluded or resolved.<sup>21</sup> Secondly, specific conflicts between the LEI insurer and the insured persons on the issue of merit should be settled efficiently. Hence, the Directive obliges member states to implement some sort of arbitration or ADR procedure in order to settle the issue of merit swiftly.<sup>22</sup>

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insurers and the common law' (1999) 8 Nottingham L.J. 6; Flood and Whyte (n 6), 92; Kilian (n 6), 42; F Cabrillo and S Fitzpatrick, *The economics of courts and litigation* (New horizons in law and economics, Edward Elgar, Cheltenham 2008) 143; G Wagner, 'Litigation costs and their recovery: the German experience' (2009) 28 Civil Justice Quarterly 379 ff.

<sup>16</sup> Rickman and Fenn (n 11) 210 ff. For German cost shifting rules, see in detail Wagner (n 15) 367 ff.

<sup>17</sup> See fn. 15.

<sup>18</sup> B Baarsma and F Felsö, *Het proces als domein - Over de effecten van het procesmonopolie van de advocatuur* (SEO Economisch Onderzoek, Amsterdam 2005) 20. Cf. G Marshall, 'The literature on the loser pays rule: an analysis of the alternatives within the ambit of the CFA with the effect on settlement strategies' (2008) 27 Civil Justice Quarterly 525, who briefly touches on the issue of litigation culture. For a more elaborate socio-legal analysis of litigation culture, see E Blankenburg, 'The Infrastructure for Avoiding Civil Litigation: Comparing Cultures of Legal Behavior in the Netherlands and West Germany' (1994) 28 Law & Society Review 789 ff.; E Blankenburg, 'Patterns of Legal Culture: The Netherlands Compared to Neighboring Germany' (1998) 46 Am. J. Comp. L. 1 ff.

<sup>19</sup> Dannemann (n 15) 290.

<sup>20</sup> For a historical background, see Werner (n 6) 249 ff.

<sup>21</sup> Solvency II, COM(2008) 119 final, Recital 55.

<sup>22</sup> Solvency II, COM(2008) 119 final Recital 56.

The third feature concerns free choice of lawyer. Article 4 (1) of the LEI Directive provides:<sup>23</sup>

Any contract of legal expenses insurance shall expressly recognize that:

(a) where recourse is had to a lawyer or other person appropriately qualified according to national law in order to defend, represent or serve the interests of the insured person in any inquiry or proceedings, that insured person shall be free to choose such lawyer or other person;

(b) the insured person shall be free to choose a lawyer or, if he so prefers and to the extent that national law so permits, any other appropriately qualified person, to serve his interests whenever a conflict of interests arises.<sup>24</sup>

The free choice of lawyer embodied in article 4 is restricted in instances when legal representation by a lawyer (attorney, barrister, solicitor or whatever the official title of this representative may be) before an official court is compulsory by law. As we will see later on, the ideal of 'free choice of lawyer' does not sit easily with the business model of some BTE providers, causing a friction that leaves the question whether article 4 should be better abolished.

### 2.3 Changing business models in BTE

The institutional environment in which BTE LEI providers operate influences the interaction between insurers and independent providers of services on the market for legal services to a large extent. BTE insurers have an obvious interest in keeping the cost of litigation low.<sup>25</sup> This may not be easily achieved in markets in which lawyers have a statutory monopoly on giving legal advice, as is the case in Germany.<sup>26</sup> Conversely, in countries where there is no such monopoly BTE insurers have every opportunity to develop their own in-house legal expertise by vertically integrating lawyers into their business. By doing so, they can achieve economies of scale and curtail agency problems inherent with outsourced legal services.<sup>27</sup> Moreover, they can be expected to attempt to broaden the scope of their product by adding easily available general legal advice to their services in order to encourage self-help and deflect potential claims at an early stage.<sup>28</sup> For example, Dutch BTE insurers have thus succeeded in keeping the number of files in which external solicitors were retained very low. Indeed, the Dutch BTE market is considered to be very much a market for 'in kind' policies in which

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<sup>23</sup> Art. 199 Solvency II Directive has similar wording.

<sup>24</sup> In England and Wales, art. 4 of the Directive was implemented with the Insurance Companies (Legal Expenses Insurance) Regulations 1990 (England and Wales), regulation 6, which adds that these rights 'shall be expressly recognized in the policy'.

<sup>25</sup> Kilian (n 6) 35.

<sup>26</sup> Ibid., 44. See also A Heinsen, *Kundesorientiertes Schadenmanagement am Beispiel der Rechtsschutzversicherung* (VWW, Karlsruhe 1997) 31-32, who is particularly critical of the German BTE market in this respect. See generally on lawyer regulation and LEI, e.g. B Baarsma, F Felsö and K Janssen, *Regulation of the legal profession and access to law - an economic perspective* (SEO Economic Research, Amsterdam 2008).

<sup>27</sup> Cf. Rickman and Gray (n 10) 311; Jackson (n 6) 580.

<sup>28</sup> Under the German model this integration of services is far less easy to achieve because of the lawyers' monopoly on legal advice. Cf. M Kilian and F Regan, 'Legal expenses insurance and legal aid - two sides of the same coin? The experience from Germany and Sweden' (2004) 11 *International Journal of the Legal Profession* 252-253.

services that are easy to access, such as advice by telephone, are as important as 'real' services, such as retaining a lawyer.<sup>29</sup>

As mentioned, by broadening the scope of their services and vertically integrating lawyers into their product, BTE LEI insurers may play an important role in bringing the cost of lawyers down.<sup>30</sup> The difference in incentive structure for law firms and BTE insurers goes a long way in explaining this phenomenon: law firms charge for services rendered (especially in case of hourly fees) whereas BTE insurers have already received their premium by the time they have to render a service. Their efforts will therefore be directed towards keeping out of court and settling at a fair level rather than maximizing the number of hours spent on a file.<sup>31</sup> Obviously, the BTE insurance arrangement in itself may pose information problems concerning quality of the service.

Generally speaking, the BTE business model of 'in kind service' seems successful in some jurisdictions and fills gaps that the German BTE model leaves. This model does, however, operate on the fringes of what is permitted in accordance with art. 4 (1) of the LEI Directive. BTE policies may well distinguish between lawyers appointed by the insurance company and lawyers selected by the policyholder, typically limiting the coverage with regard to the latter at a lower amount than with regard to the former. Under certain conditions this distinction may run counter to the ideal of free choice embodied in article 4.<sup>32</sup> In any jurisdiction that does not assign legal services (including advice) exclusively to lawyers, article 4 will create a tension between economical insurance practice and legal principles. This tension will not dissolve, because BTE insurers will still have a legitimate interest in testing the merits of the case and strategy. Therefore, a BTE insurer will typically want to stipulate that he will only cover legal expenses if:

- It is probable that the insured will prevail in litigation (reasonable prospects of succeeding with the claim)
- The case has been approved as viable by an assigned panel lawyer and the insurer has agreed to the expense
- The policyholder does not stop or settle a claim or withdraw instructions from the appointed solicitor without good reason

Moreover, it is not uncommon for a policy to stipulate: "We will choose an appointed representative to act for you. If you are not satisfied with the appointed representative we

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<sup>29</sup> Maas (n 7)127. Cf. on diversification of the BTE product Prais (n 11) 435.

<sup>30</sup> The insurance industry is said to play a pivotal role across the board in keeping legal costs of settlement and litigation low (see, eg, HM Kritzer, 'The Commodification of Insurance Defence Practice' (2006) 59 *Vanderbilt L.Rev.* 2053 ff. on shopping around behaviour by insurers for cost-efficient defence lawyers.)

<sup>31</sup> Note that Dutch LEI policyholders are quite content with the legal services offered by their insurance companies. See *Rechtsverzekeringen in beeld* (Verbond van Verzekeraars, Den Haag 2008). Cf. Baarsma and Felsö (n 18) 26.

<sup>32</sup> Note that in its decision of January 3, 2005, the Dutch (formerly self-regulatory) supervisory council for the insurance industry (*Raad van Toezicht Verzekeringen*) declared this practice inconsistent with article 4 of the EC Directive (Raad van Toezicht Verzekeringen nr. 2005/006; see <http://www.kifid.nl/uploads//jurisprudentie/2005-006%20Rbs.pdf> ; accessed April 2009.



have chosen, you can choose another appointed representative” and “We may choose not to accept an appointed representative of your choice but this will only be in exceptional circumstances.” By thus shaping the BTE LEI contract, the insurer remains in control of the choice of lawyer and minimizes control of the insured over the policy.<sup>33</sup>

Unsurprisingly, the interests of the BTE LEI insurer do not necessarily converge with the interests of the policyholder with regard to both merits and free choice of counsel. As article 4 does not specifically oblige insurers to actively disclose the right of free choice of counsel to the policyholder, these rights are more or less obscured in the small print.<sup>34</sup> And even if insurers were to actively disclose this right to the policyholder in the claims process, there would still be the matter of *merit*. The Directive does not restrain the insurer from assessing merit before allowing the policyholder to litigate.<sup>35</sup> So, the policyholder does have a choice of counsel but he cannot force the insurer to fund unmeritorious claims.<sup>36</sup>

Although article 4 is undoubtedly founded on the fundamental principle that in civilized societies citizens should be given the right to choose their counsel, there is something to be said for the position that this principle should be considered less fundamental in private insurance contracts.<sup>37</sup> Possibly, explicitly introducing the power to waive the right acquired under article 4 before or after the event could build up leverage for more competition in the market for legal services.<sup>38</sup> Moreover, the European legislature should reconsider article 4 anyway in light of the fact that insurance innovation (such as the upsurge of ATE) can easily render the article out of date.<sup>39</sup>

### 3 After the event (ATE) Funding and Insurance

#### 3.1 ATE third party funding

After the event (ATE) funding and insurance arrangements reflect in some ways legal BTE LEI. The specific contract details, however, define the exact nature of the agreement. To appreciate what one is specifically dealing with one should read the exact contract terms. Some of these ATE contracts correspond with contingency fee arrangements, others

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<sup>33</sup> Cf. Rickman and Gray (n 10) 311-312.

<sup>34</sup> Solvency II does little to force insurers to disclose this right in any other manner than in the general contract terms, leaving every opportunity for de-emphasizing this right.

<sup>35</sup> The policy should stipulate that, in case of dispute over merit, recourse can be had to some kind of arbitration procedure; art. 6 Directive 87/344(= art. 201 Solvency II).

<sup>36</sup> Moreover, there is the issue of interpretation of article 4. In England, art. 4 of the Directive is strictly interpreted as merely giving a right to choose counsel from the moment proceedings are issued, leaving the claimant in the hands of his BTE LEI panel solicitor prior to proceedings. See G Wignall and S Green (eds), *Conditional Fees - A Guide to CFAs and Litigation Funding* (3d Ed. edn The Law Society, London 2008) 170; Prais (n 11) 435. A similar strict interpretation is to be found in the Netherlands; Baarsma and Felsö (n 18) 58.

<sup>37</sup> For criticism of art. 4, see Baarsma, Felsö and Janssen (n 26)125.

<sup>38</sup> Cf. Baarsma and Felsö (n 18) 33.

<sup>39</sup> A case in point is Case C-1999/08 *Eschig vs. Uniqua Sachversicherung* (ECJ 10 September 2009), forbidding the LEI insurer to reserve the right in case of a mass damage event to select itself the legal representative of all insured consumers concerned.

approximate insurance contracts. What all have in common, however, is that ATE is exactly what the name suggests: an agreement entered into by the claimant (or his lawyer operating under some form of *conditional fee agreement*, in short: CFA) after the dispute has already arisen.<sup>40</sup> It seems that there are at least two distinct versions of ATE arrangements currently available in Europe.<sup>41</sup> The first is ATE *funding* and is dealt with in this section. The second, ATE *insurance*, is a product which is especially popular on the English market; we will concern ourselves with this insurance in the next section.

In Germany and Austria the typical ATE funding product is the *Prozessfinanzierungsvertrag*.<sup>42</sup> It is offered both by companies with a track record in underwriting as well as companies with experience in capital investment.<sup>43</sup> In England and Wales, where this type of arrangement is advancing as well, it is usually referred to as *third party funding*.<sup>44</sup>

In short, this type of contract typically entails the following:

- The ATE provider will typically offer to finance all costs involved in a money claim, against a 'premium' which is due only in case of success.<sup>45</sup>
- The provider diligently investigates the creditworthiness of the defendant and the viability of the claim (with the help of legal opinion of the lawyer who analyzes the case)
- If the claim is found valid, ATE will provide the upfront funding required
- The success premium is both contingent on the disputed amount and staged (e.g., 20% in case of pre-trial settlement, 30% in case of success in court up to € 500,000, 20% of amounts over € 500,000)<sup>46</sup>
- This ATE arrangement is typically available for (mainly commercial) claimants with high value claims (e.g., € 50,000-80,000 and upwards) with a high success probability.<sup>47</sup>

ATE funding operates in a segment of the market where there is little competition to be expected from BTE LEI. In any event, the economics applied in ATE funding are different from BTE insurance in the sense that the idea of pooling of risks may be a less prominent feature of ATE than it is in BTE. Instead, the selection criteria applied by the ATE provider assure a relatively comfortable chance of collecting high revenues. ATE providers typically favour contractual money claims over tort claims (which may turn out to be especially complicated if liability and causation are contested) and they assure themselves of the

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<sup>40</sup> Kilian, 'Alternatives to Public Provision: The Role of Legal Expenses Insurance in Broadening Access to Justice: The German Experience' 33; Jackson (n 6) 156.

<sup>41</sup> A rough idea of how the markets are currently developing can be gleaned from Wignall and Green (n 36) 192 ff.; Jaskolla, *Prozessfinanzierung gegen Erfolgsbeteiligung* (Verlag Versicherungswirtschaft, Karlsruhe 2004) 4 ff.; Jackson (n 6) 156 ff.

<sup>42</sup> On these contracts, see, eg, M Coester and D Nitzsche, 'Alternative ways to finance a lawsuit in Germany' (2005) 24 *Civil Justice Quarterly* 49 ff; 83 ff.

<sup>43</sup> See, eg, Veith and Gräfe (n 6) 973 ff. Allianz Litigation Funding, Claims Funding International, Foris and 80e are some of the providers active in Europe.

<sup>44</sup> Jackson (n 6) 160 ff.

<sup>45</sup> In England, percentages vary between 30 and 60; *Ibid.* 156-159.

<sup>46</sup> Terms Allianz ProzessFinanz GmbH (Austria).

<sup>47</sup> Veith and Gräfe (n 6) 975-976. Jackson (n 6) 161. In Germany, ATE is also provided for smaller claims. See Coester and Nitzsche (n 42) 51-52, 88. However, given that the German consumer insurance market is saturated by BTE, high penetration rates of this form of ATE seem unlikely.

defendant's solvability.<sup>48</sup> Since ATE providers take a monetary interest in the case contingent on outcome, it seems doubtful if the contract they offer can be regarded as an insurance contract in the classical sense. Essentially, the 'premium' (a percentage of the recovered amount) is only due when the claimant prevails, and even then the claimant does not have to incur any out-of-pocket expense because the 'premium' is deducted from the proceeds. All in all, this type of ATE funding bears more resemblance to a contingency fee arrangement than to insurance.<sup>49</sup> Unsurprisingly, the selection process applied by lawyers working under a US-style contingency fee arrangement is replicated.

The benefits of this type of ATE to impecunious and/or risk averse (commercial) claimants are self-evident, and in those jurisdictions that restrain lawyers admitted to the bar from charging their clients on any other basis than a (fixed) hourly fee the ATE arrangement has the potential of becoming a competitive product. It seems likely, moreover, that restrained lawyers would be tempted to associate themselves somehow with ATE providers. It is not difficult to imagine that in the near future legal systems will be faced with the question whether lawyers would be allowed to accept commission for clients they refer to the provider.<sup>50</sup>

### 3.2 ATE as an add-on insurance with CFA

The institutional setting and practical operation of English ATE insurance is somewhat different from the ATE funding I described in the previous section. In England and Wales, under an ATE funding arrangement the success fee would typically be deducted from the award (as it typically is in Germany),<sup>51</sup> whereas under specific conditions English costs rules allow for a specific CFA+ATE insurance arrangement. This typically English arrangement may be much more beneficial to the claimant. In essence, it works as follows.

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<sup>48</sup> Coester and Nitzsche (n 42) 87-88.

<sup>49</sup> Cf. Jaskolla (n 41) 35 ff. In the definition of 'legal expenses insurance' of art. 2 Directive 87/344/EEC, premium is a precondition. Note, however, that the mere fact that the insured does not have to pay the premium in itself does not necessarily preclude the arrangement being an insurance contract. For instance, M Clarke, *Policies and Perceptions of Insurance Law in the Twenty-First Century* (Oxford University Press, Oxford 2007) 22 and 347 ff. is very cautious in formulating an all-encompassing definition for English law. Under German law, the definition of an insurance contract specifically includes the duty of the policyholder to pay a premium (§ 1 (2) Versicherungsvertragsgesetz), which would lead to a tension under German law at least between the legal and the economic reality of CFA+ATE arrangements. Finally, note that under German law it has been argued that ATE third party funding is in fact a contract of (silent) partnership; see B Grünwald, 'Prozessfinanzierungsvertrag mit gewerbsmäßigem Prozessfinanzierer - ein Gesellschaftsvertrag' (2000) 55 Betriebsberater 729 ff.; Jaskolla (n 41) 72 ff.; Coester and Nitzsche (n 42) 95. Others argue that it is a contract 'sui generis'; cf. Eversberg, in: Veith and Gräfe (n 6) 962-963; H Buschbell, 'Prozessfinanzierung als Instrument der Anspruchsverfolgung' (2006) AnWB 829; F Frechen and ML Kochheim, 'Fremdfinanzierung von Prozessen gegen Erfolgsbeteiligung' (2004) Neue Juristische Wochenschrift 1214; N Dethloff, 'Verträge zur Prozessfinanzierung gegen Erfolgsbeteiligung' (2000) Neue Juristische Wochenschrift 2226-2227.

<sup>50</sup> In England, this problem already reared its head. See § 307 (d) Bar Code of Conduct; Bar Council Guidance on Conditional Fee Agreements, Part 1, nr. 8.

<sup>51</sup> Jackson (n 6) 163-164.

For certain types of claims solicitors are permitted to offer their services under a CFA (conditional fee arrangement). CFA denotes a combination of *no-cure-no-pay* and a *success fee*, a mark-up success fee, either in the form of a flat fee or an upscale fee expressed as percentage of basic hourly fee, but not contingent on the amount of the sum successfully recovered. Under the CFA, if the claimant is defeated in court his solicitor will not claim any remuneration. There is, however, still the issue of the prevailing defendant's costs. English costs rules allow the claimant to take out ATE insurance covering these costs. If the claimant wins the case, he is allowed to shift the costs of both his lawyer's fee and the ATE insurance premium onto the defendant.<sup>52</sup> Unsurprisingly, the ATE+CFA arrangement has proved extremely popular with English claimants, leaving ATE funding little opportunity to germinate in those areas where ATE+CFA is allowed.<sup>53</sup>

As mentioned, ATE is taken out by clients to cover the residual risks associated with CFA. Under the ATE contract, the insurer undertakes to reimburse the insured for the costs incurred under the 'English rule'.<sup>54</sup> The defendant does not experience any specific financial consequences if he prevails. If he loses, however, he is forced to reimburse the claimant for the ATE insurance premium.<sup>55</sup> This is somewhat awkward in the sense that the losing opponent has to pay for the risk-aversion of the winning party. Moreover, the CFA gives the claimant's lawyer the right to a success fee (up to as much as 100% of what he normally charges per hour), so the stakes are raised considerably: if the defendant loses, he will have to pay the normal hourly fee, the success fee and the ATE insurance premium (not to mention his own costs).<sup>56</sup>

ATE is available for cases with prospects of 65 percent or more, the premium is some 20-30 percent of the amount of cover required. Hence, while CFA takes away the risk of having to pay one's own solicitor, the ATE lifts the residual risk of losing the case and having to foot the opponent's bill. This puts both the ATE insurer and the lawyer in the position of risk assessor as the claimant does not experience any financial consequences other than forfeiting the ATE premium if he loses the case.

In recent years, even the risk of paying the ATE premium has been lifted from specific claimants' shoulders. In the past, deferred payment and a rebate premium was commonly applied if the claimant failed in court, but in recent years English costs regulation has gone one step further by allowing the concept of 'self-insured deferred premium' to be applied. Incontestably, this concept has proved immensely popular with claimants. It is easy to see why: under a self-insured CFA+ATE arrangement the insured claimant does not have to pay premium upfront but only afterwards. If he wins the case, the full premium is shifted entirely

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<sup>52</sup> Ibid. 167.

<sup>53</sup> Note that CFA and ATE are not universally available for all claim types. See generally Wignall and Green (n 36) 19 ff.

<sup>54</sup> Cf. McDonald, Winters and Harmer (n 12) 13-14.

<sup>55</sup> See fn. 59.

<sup>56</sup> S Sime and D French (eds), *Blackstone's Civil Practice 2009* (Oxford University Press, Oxford 2008) 89 (Ch. 6.2).

onto the defendant and if the claim is unsuccessful in court no premium is charged at all.<sup>57</sup> As a result, a claimant who is secured by CFA+ATE does not run the financial risk of losing. So, if a solicitor and an ATE insurer are willing to financially underwrite a claim with a CFA+ATE “quality mark”, they signal great confidence in a victory to the defendant, even more so as the arrangement may expose the opponent to increased costs as compared to hourly fees. Hence, an opponent faced with a CFA+ATE may be more willing – rightly so or not – to settle than he otherwise might have been. He can also be expected to have an interest in knowing if the claimant has ATE and if so, what the exact premium build-up is. Currently, the insured must indeed inform both the court and defendant that he took out an ATE insurance, but in principle the level of premium does not have to be disclosed.<sup>58</sup> This puts defendants in the position of a participant in a rather uncomfortable *sunk cost auction*, which I will discuss later.

In theory, the reasonableness of the premium charged by the ATE is to be scrutinized by the cost judge<sup>59</sup> but because judges have little expert knowledge on the operation of insurance markets in general, let alone the rather intransparent market of ATE insurance,<sup>60</sup> chances are that insurance companies may have less than an optimal incentive to set their premiums at a competitive level.<sup>61</sup> Moreover, claimants – win or lose – have no interest in finding the cheapest ATE as they will not pay the premium. This is especially difficult with regard to the deferred ‘premium’ that is conditional on the stage of the procedure (staged or stepped) or even topped-up if the claimant wins the case. Restrictions on topped-up premiums seems indispensable because neither the claimant nor his lawyer has any interest in keeping the success premium down by searching for the cheapest success premium. Hence, the insurer can thus easily create negative externalities for losing opponents.<sup>62</sup> Furthermore, it is the solicitor who offers the CFA+ATE arrangement to his client and who will recommend a certain ATE provider. This may in turn create an environment for unhealthy relationships between solicitors and ATE providers.

So, the upshot of all this is that a prevailing claimant can fully shift the costs of his solicitor and his ATE premium onto the defendant and a defeated claimant doesn’t pay anything. The CFA+ATE industry justifies this on the basis that the policy is “self-insured”, which actually implies that the insurer pools all risks and funds all the unsuccessful cases from premiums charged to defendant in successful cases.<sup>63</sup> So, what “self-insured” really means is allowing

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<sup>57</sup> Jackson (n 6) 479 refers to this arrangement as the “magic bullet”. I think “poison arrow” would be a more suitable name.

<sup>58</sup> See Sime and French (n 56) 85-86 (Ch. 5.11).

<sup>59</sup> S. 29 Access to Justice Act 1999, Rule 44.5 CPR, par. 11.10 CPD. See Sime and French (n 56) 85 (Ch. 5.10); Wignall and Green (n 36) 73 ff.

<sup>60</sup> Cf. Jackson (n 6) 479-480.

<sup>61</sup> Wignall and Green (n 36) 202. Although ATE insurers deny this, they do admit that there is little experience with premium setting. See Jackson (n 6) 159.

<sup>62</sup> Wignall and Green (n 36) 79-81. Note that this problem slightly resembles the practice of charging alternative tariffs for car rentals: one for common rentals and one (markedly higher) for replacement cars in case of accidents for which a third party is liable. Cf. the English ‘credit hire industry’ as described by Jackson (n 6) 28.

<sup>63</sup> Wignall and Green (n 36) 190; Jackson (n 6) 16-17, 30, 478. Jackson (n 6 at 474) rightly notes that if cost shifting against claimants were to be abolished, the main purpose of ATE insurance premiums would disappear.

claimants and insurers to design an aleatory contract through which the costs of both parties can be fully externalized on third parties. It is as awkward as a legal system that would allow fire insurers to recoup the aggregate costs of fires whatever their cause from convicted arsonists.

#### 4 Observations

Two issues seem to emerge from the previous that are worthy of some further reflection. Firstly, the long-term sustainability of some ATE products. Secondly, the challenges faced by policymakers that would like to nudge consumers into voluntarily taking out BTE LEI.

As concerns the legal nature of ATE products we should be cautious in using the noun 'insurance'. It seems that the ATE in England and Wales, CFA+ATE arrangements bears more resemblance to insurance contracts<sup>64</sup> than the ATE funding arrangements that have entered the German and Austrian markets. The continental version of ATE is in fact much more a contingency fee arrangement offered by capital investors willing to invest in the legal costs in return for a cut of the expected proceeds. In fact, it seems doubtful this can truly be considered an insurance contract.

As regards the utility of the CFA+ATE arrangement for keeping a fair balance between promoting access to justice for impecunious claimants and giving defendants the appropriate incentive for settling valid claims at reasonable costs, I have strong reservations. My impression (as an outsider) is that the current legal framework in England and Wales does little to stimulate the development of an ATE market functioning adequately. On balance, the English CFA+ATE practice is a far worse deal for defendants than the continental ATE practice. The English cost shifting rules in themselves may already incite a *sunk cost auction*: as the costs of loosing are unpredictable, litigants may be tempted into investing just a little more with every procedural step the opposing party takes.<sup>65</sup> Obviously, not only the disputed amount itself is at stake but also the costs of the opposing litigant. On the other hand, uncertainty on these costs may constitute a countervailing psychological force: unpredictability may enhance willingness to settle at an early stage, even if contesting the claim in itself may seem reasonable.<sup>66</sup> The question is whether an undiluted English rule, combined with the CFA+ATE leverage, sets the right level of willingness to issue or settle. Indeed, high stakes and a certain level of unpredictability of outcome may in fact cause an

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<sup>64</sup> Cf. the definition of ATE insurance premium in CPR 43.2 (m): "a sum of money paid or payable for insurance against the risk of incurring a costs liability in the proceedings, taken out after the event that is the subject matter of the claim".

<sup>65</sup> Cf. Cabrillo and Fitzpatrick (n 15) 163-164 ; R Bowles and N Rickman, 'Asymmetric Information, Moral Hazard and the Insurance of Legal Expenses' (1998) 23 Geneva Papers on Risk & Insurance - Issues & Practice 200. Cf Beckner and A Katz, 'The Incentive Effects of Litigation Fee Shifting When Legal Standards Are Uncertain' (1995) 15 International Review of Law and Economics 206. Marshall (n 18) 526 seems to suggest that the auction-effect is exacerbated by the CFA+ATE arrangement. See also Cabrillo and Fitzpatrick 222-223, who argue that policymakers should consider introducing scales in order to reduce the cost of litigation.

<sup>66</sup> A feature that German costs law seems to lack, according to Wagner (n 15) 382.

inefficient level of litigation by causing either too much settlement by risk averse and too little settlement by risk neutral litigants.<sup>67</sup> I for one would expect English corporate defendants, faced with a claimant carrying CFA+ATE protection, to be far more willing to settle than under any other arrangement. One can only speculate if inefficiencies such as over deterrence are indeed involved. I personally would expect empirical evidence to show that the current English system enhances the nuisance value of relatively minor and straightforward claims, potentially causing overcompensation in that area.

Finally, we turn to the second point of reflection, the challenges policymakers face when thinking of nudging consumers into taking out BTE LEI voluntarily. From the outset it is clear that BTE is by no means a panacea for funding civil litigation. It can hardly be considered a complete substitute for legal aid. However, it can be a useful addition to the mix of funding instruments. If it is true that middle-class households are increasingly ineligible for legal aid and are increasingly facing financial obstacles on their paths to justice, nudging these households into taking out comprehensive BTE insurance seems a policy choice worth considering. Choices are never made in a sterile environment and always with a default position from which the choice should deviate. Possibly this default position may prove to be 'sticky'.<sup>68</sup> If policymakers would like to influence households into taking out BTE, they might want to consider persuading household insurers into offering policies with a comprehensive BTE added on.<sup>69</sup> Consumers would have to actively un-tick the BTE box to opt-out from the BTE module. Assuming that household insurance is bought by most house owners, as their mortgage conditions usually compel them to do so, this would lead to a large risk pool (provided the default is indeed sticky). This may even help policymakers to shift legal aid from the tax budget to private LEI without experiencing serious problems of adverse selection and need for risk differentiation, thus facilitating some level of welfare redistribution through private insurance contract.<sup>70</sup>

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<sup>67</sup> Cf. P Fenn and N Rickman, 'Asymmetric Information and the Settlement of Insurance Claims' (2001) 68 *Journal of Risk and Insurance* 627. Cf. Beckner and Katz (n 65) 215, who argue that cost-shifting rule is superior if care is irrelevant for liability and legal certainty is high.

<sup>68</sup> On sticky defaults, RB Korobkin, 'The Status Quo Bias and Contract Default Rules' (1998) 83 *Cornell Law Review* 608 ff.

<sup>69</sup> Alternatively, policymakers might want to consider nudging insurers that have already secured a large risk pool of BTE policies added on to household or car insurance into extending the BTE cover to fill gaps left by the retreat of legal aid.

<sup>70</sup> On that issue WH van Boom, 'Insurance Law and Economics: an empirical perspective' in M Faure and F Stephen (eds), *Essays in the Law and Economics of Regulation - in Honour of Anthony Ogus* (Intersentia, Antwerp/Oxford/Portland 2008) 265.