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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

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Abstract

The right of access to civil justice is a cornerstone of the Belgian legal order. At present time, however, financial barriers prevent about three quarters of the Belgian population from fully asserting their subjective rights. As traditionally, apart from legal aid, private funding is the dominant method of funding a civil claim in Belgium, alternative funding options in between private and public funding might hold some prospects for improving the access to civil ustice. Therefore this paper aims to provide an in-depth economic analysis of the effects of cost shifting, client-lawyer fee arrangements and legal expenses insurance on the various dimensions of the access to civil justice. In summary, the main results from the analysis are that theoretically all three alternative funding methods may hold certain prospects for improving the accessibility of civil justice. But, as far as empirical data are available, cost shifting fits least the requirements for solving the policy issue addressed in this paper. However, the validity of this empirical observation is subject to certain limitations. Both contingency fees and legal expenses insurance hold clear prospects for overcoming risk aversion and liquidity constraints. Also, relative to hourly fees, the incentive scheme inherent to contingency fees appears most appropriate to curb lawyer opportunism. The involvement of a legal expenses insurer may lead lawyers to behave less opportunistically too. Finally, within the current legal framework, insurers' control of costs and quality requires their direct or indirect involvement in the civil justice administration system. This may pose some challenging policy issues as the market for legal expenses insurance further develops in the future.

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[1]

Tom SCHEPENS

The right of access to civil justice is a cornerstone of the Belgian legal order. At present time, however, financial barriers prevent about three quarters of the Belgian population from fully asserting their subjective rights. As traditionally, apart from legal aid, private funding is the dominant method of funding a civil claim in Belgium, alternative funding options in between private and public funding might hold some prospects for improving the access to civil justice. Therefore this paper aims to provide an in-depth economic analysis of the effects of cost shifting, client-lawyer fee arrangements and legal expenses insurance on the various dimensions of the access to civil justice. In summary, the main results from the analysis are that theoretically all three alternative funding methods may hold certain prospects for improving the accessibility of civil justice. But, as far as empirical data are available, cost shifting fits least the requirements for solving the policy issue addressed in this paper. However, the validity of this empirical observation is subject to certain limitations. Both contingency fees and legal expenses insurance hold clear prospects for overcoming risk aversion and liquidity constraints. Also, relative to hourly fees, the incentive scheme inherent to contingency fees appears most appropriate to curb lawyer opportunism. The involvement of a legal expenses insurer may lead lawyers to behave less opportunistically too. Finally, within the current legal framework, insurers' control of costs and quality requires their direct or indirect involvement in the civil justice administration system. This may pose some challenging policy issues as the market for legal expenses insurance further develops in the future.

Introduction

The right of access to civil justice is a cornerstone of the Belgian legal order. In this respect reference can be made to Article 6 of the European Convention on Human Rights, Article 13 of the Belgian Constitution and the corresponding general principle of law. Furthermore, according to Article 23, 2° of the Belgian Constitution everyone is entitled to legal assistance. This social-civil right carries with it the government duty to prevent that financial barriers restrain subjective rights from being asserted[2]. At present time, however, this is only the case for about one quarter of the Belgian population: about 10 pct of the Belgians seeking justice

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[1] Award Winning Thesis, European Master Program in Law & Economics (EMLE), Academic Year 2005-2006. This paper, which is currently being revised, benefited from the comments of, among others, Louis T. Visscher and Jef De Mot. All mistakes are, of course, my own. Please, address any comments to Tom Schepens, Ghent University, School of Law, Center for Advanced Studies in Law & Economics, Universiteitstraat 4, B-9000 Ghent, Belgium, e-mail: tom.schepens@ugent.be.

[2] Hoge Raad voor de Justitie (2002) at 7.

do not face any financial restriction and approximately 15 pct is eligible for legal aid[3]. For the other 75 pct of the population the fundamental policy question remains to be solved, how their financial access to civil justice can be improved.

Traditionally, apart from legal aid, private funding is the dominant method of funding a civil claim in Belgium. That is, typically the costs of pursuing a civil lawsuit are, apart from minor exceptions, born by the plaintiff himself. Given the magnitude, unpredictably and timing of legal expenditures, there is little doubt that the current financial inaccessibility of civil justice stems mainly from a lack of alternative funding options in between private and public funding. In this paper, three possible options for bridging this funding gap are surveyed for their potential of improving the access to civil justice. Each of these alternatives entails a certain litigation cost reallocation: an indemnity rule shifts litigation costs from the prevailing to the losing party at trial, in a fee arrangement costs can be reallocated from the client to his lawyer, and finally, costs of litigation can be covered by a legal expenses insurer.

Recently, the Belgian Supreme Court has implicitly pointed at the first of the abovementioned reallocation mechanisms as a possible solution to the policy question addressed in this paper. In a sequence of judgments, it has acknowledged the possibility that attorney and expert costs are shifted from the winning to the losing party at trail, first, in the area of tort law (judgment of February 28, 2002), thereafter, in the area of contract law (September 2, 2004) and finally, as a general principle of law (May 5, 2006)[4,5]. Not surprisingly, however, these judgments are fairly vague and admit of more than one interpretation. A fierce debate on cost shifting and its prospects for improving the access to civil justice was the anticipated result. When this paper was completed in August 2006, the legal vacuum the Supreme Court had left behind was still not filled. A legislative intervention that would make an end to the heated discussion was still awaited.

Lately, also the other alternative funding options that are subject to this study, have gained in attention. In England and Wales, for example, conditional fee arrangements and legal expenses insurance moved to the fore after major reforms of the legal aid scheme in 1999. Further, the traditional success of legal expenses insurance in Germany and contingency fees representing the average person's "key to the courthouse"[6] in the US are both suggestive of the pivotal role cost reallocation can play in keeping civil justice affordable in the 21st century.

This paper is organized as follows. In the first chapter, an economic dispute resolution model is developed that serves as the core of the economic analysis presented in this paper. Thereafter, the various dimensions of the access to civil justice that are relevant from a policy point of view, are determined. In chapter two till four, respectively cost shifting, fee arrangements and legal expenses insurance are researched for their effects on each of these

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[3] Ministerraad (2003) at 1.
[4] The judgments of the Belgian Supreme Court are available at <http://www.cass.be>.
[5] Lamon (2006) at 12 (interpreting the final judgment of the Supreme Court in the most evolutionary way).
[6] Corboy (1976) at 27-28.

dimensions, both from an economic and empirical perspective. The final chapter concludes with a brief comparative overview of our findings.

I.   Civil Justice Disentangled

In this chapter, first, the chronology of a civil dispute is analyzed from an economic point of view. For that purpose, we rely on the standard economic theory of litigation as derived by, among others, Landes (1971), Gould (1973) and Posner (1973)[7]. In a second section, the various dimensions of the access to civil justice are determined, that should be distinguished in order to be able to properly assess the effects alternative funding options have on the accessibility of civil justice.

I.1.   Economic Dispute Resolution Model

Basically, the chronology of a civil dispute falls apart in five different stages[8]. Given the economic approach upheld in this paper, the actors in each of these stages are assumed to be 'rational'. That is, they are forward looking and behave deliberatively and consistently so as to maximize their expected utility[9,10]. Therefore, contrary to the traditional legal approach, the first stage of the economic dispute resolution model does not take a breach of a rule of substantive law as a starting point, but includes all behavior, irrespective of whether it constitutes a breach of civil law or not. This makes sense, for all behavior with respect to the law is assumed to be in anticipation of legal proceedings that might follow. An agent's conduct in the first stage of the model is thus assumed to be the result of trading off expected costs and benefits of every possible conduct and finally, choosing that particular behavior that he expects will maximize his personal welfare.

At the filing stage, a person (*plaintiff*) that in the first stage suffered by another actor's behavior (*defendant*) that was allegedly in violation of the law, decides whether or not to bring suit. The latter is here interpreted as the filing of a claim, either officially (registering the case at the court's office) or informally (private communication between the parties). Once again, underlying this decision is a cost-benefit calculus. In this respect, it's of fundamental importance to understand that since bringing suit is costly – it uses plaintiff's time and/or money – a plaintiff will only file suit, if and only if, he has a credible threat thereafter to go to trial. In principle, this will only be the case if the *claim's expected value* is

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[7] For a comprehensive overview of the basic theory of litigation, including some illustrative mathematical examples, see Shavell (2004) at 389-418. See also Cooter and Rubinfeld (1989). The economic model developed in this chapter relies heavily on this literature.

[8] The chronology of a civil dispute as presented in this section and applied throughout this paper is, of course, only a simplification of reality. Notwithstanding the fact that the different stages of the dispute resolution process are presented here as if they are strictly consecutive, in practice, typically considerable overlap occurs. The parties are assumed to view a dispute solely as a financial matter. Also, the model abstracts from the possibility of alternative dispute resolution. See on alternative dispute resolution, Shavell (1995).

[9] Ulen (1999) at 791-92.

[10] If not stated differently, parties are assumed to be risk-neutral and thus to evaluate an uncertain prospect by its expected value, i.e. by discounting possible outcomes by their probabilities.

positive, that is, when the expected judgment (the potential award multiplied by the probability of success[11]) exceeds the expected cost[12]. In absence of such a credible threat in the defendant's view, the latter won't fear trial and would consequentially refuse to concede anything at all during settlement negotiations.

These settlement negotiations will only follow insofar as the claim is not dropped. At the drop stage, the plaintiff revaluates the expected costs and benefits of pursuing his claim on the basis of the information that has become available after suit was brought. If it turns out that the *claim's expected value* is no longer positive, he will, in principle[13], rationally decide to drop it.

If the plaintiff didn't abandon his case, settlement negotiations are supposed to follow. Indeed, insofar as legislation and courts don't encourage – if not require – parties to endeavour settlement, the risk, expected costs and length of trial induce most parties to try to resolve their dispute amongst one another. A prerequisite to a successful bargain is the existence of a *positive* settlement range (and corresponding *settlement surplus*). That is a range of potential settlement amounts that leave both parties better off than they would be if they went to trial. This implies that the plaintiff gets at least his estimate of the expected judgment, net of expected litigation costs, and the defendant is due at the most his estimate of the expected judgment, plus expected litigation costs[14]. The difference between both parties' threat values is the settlement surplus: it equals the sum of both parties' litigation costs minus the amount by which the plaintiff's estimate of the expected judgment exceeds the defendant's[15]. Whether, if the cooperative surplus is positive, settlement actually occurs, depends on the nature of bargaining between the parties and the information they have about each other[16].

In the fifth and final stage, suits which didn't settle are adjudicated by a court (*adjudication*). In course of trial proceedings, each party will rationally spend on litigation up to the point where an additional investment increases the expected judgment by no more than its expected cost, i.e. the point where the expenditure's marginal cost equals its marginal benefit.

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[11] See *infra* text accompanying note 19.

[12] There is an important exception to this rule: in some cases, it may well be rational for a plaintiff to bring suit although the expected judgment would be outweighed by its costs if the judicial process were to be completed instantly. For a comprehensive overview of the existing theories on these 'negative-expected-value suits', see Bebchuk (1998). Our analysis abstracts from this possibility and assumes that a claim is only brought if it has a positive expected value, see also further *infra* text accompanying note 20.

[13] See *supra* previous note.

[14] As trial costs are typically much greater than settlement costs, for simplicity both parties' settlement costs are assumed nil.

[15] Formal proof of this proposition is provided in Cooter and Rubinfeld (1989) at 1075.

[16] Since Shavell (1982) and P'ng (1983) introduced respectively asymmetric information and strategic behavior into the analysis of settlement bargaining, the analysis has evolved from static to dynamic. For an overview of recent developments in modeling of pretrial settlement bargaining, see Daughety (1999), Daughety and Reinganum (2005). In this paper, the effect of litigation cost reallocation on the settlement rate is solely assessed on the basis of the existence and size of a *positive settlement surplus*.

I.2   Civil Justice: A Multi-Dimensional Concept

It follows from the economic dispute resolution model that, strictly speaking, there is only one access to civil justice: the filing of suit. However, notwithstanding its indispensability – 'no suit, no justice' – it would be incomplete to restrict our analysis to the level of suit. First, because civil justice is only administrated through settlement or adjudication, and thus only insofar as a filed claim is not disposed of at the drop stage. Second, because (the access to) civil justice is a multi-dimensional concept[17]. It is a good that exhibits certain features, which all add to its overall value. On that account, rather than focusing on one single feature, a well-established civil justice policy aims at maximizing its overall value, taking into consideration all of its dimensions. This holds whatever the grounds are on the basis of which this valuation is done.

Therefore, in order to maximize its social bearing, the strictly positive analysis presented in this paper also controls for the effects of litigation cost reallocation on claim disposition, claim quality, the duration of claims and litigation costs[18]. Respectively each of these variables reflect one or more aspects of the access to civil justice (in a broad sense) that are commonly perceived as issues of social concern: the promotion of private over public dispute resolution, determent of meritless litigation and lowering the burden on the judicial administration by keeping small claims out of court, reducing delay in civil proceedings and the affordability of civil justice.

As concerns claim quality, it would be most correct if it were analyzed in terms of a probability distribution of all possible outcomes at trial. For simplicity, however, hereafter, the outcome of a case is assumed dichotomous ('all or nothing') and its quality is evaluated in terms of a single amount at stake (*potential award*) and a single probability of success[19]. The former is assumed to be constant and to be estimated alike by both disputants. The latter reflects the merits of the case, i.e. its *legal quality* which depends on the extent to which the law and facts underlying the case are in support of the claim.

Finally, before we turn to the core of this essay, one last caveat should be made. As in this paper the level of suit is analyzed from the viewpoint of the accessibility of justice, the indirect effect litigation cost reallocation has on future-defendants' ex-ante behavior is exogenous to the analysis. The level of suit is determined solely by taking into account a claim's expect value and the extent to which an alternative funding option allows a plaintiff to overcome potential risk aversion and liquidity constraints[20]. The possibility that a change in the accessibility of justice leads future-defendants to cause less conflictuous situations in the

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[17] See also Zuckerman (2002).

[18] As civil justice implies the correct application of the law to the facts of the case, accuracy of dispute resolution qualifies for a dimension of the access to civil justice too. Nevertheless, given the limited scope of this paper, accuracy is not included in the analysis as it fits least the empirical approach of this paper. It does not really allow for empirical testing due to the lack of a good proxy for the rectitude of adjudication, see Botero et al. (2003) at 75-76. For some basic insights into how litigation cost reallocation may affect the accuracy of dispute resolution, see Cooter and Rubinfeld (1989) at 1087-88.

[19] Multiplying both gives the *expected judgment*, see *supra* text accompanying note 11.

[20] See also *supra* note 12.

first stage of the economic model, thus affecting the likelihood of suit, is not taken into account. Level of suit should here thus be interpreted as the probability that a *given* claim is brought.

II.   Cost Shifting

Before the Belgian Supreme Court's judgments of February 28, 2002, September 2, 2004 and May 5, 2006, it was traditionally accepted that in Belgium, such as in the US, each party to a civil dispute had to bear his own attorney and expert costs, irrespective of the outcome at trial. However, other litigation costs such as court fees were already before subject to a cost-shifting rule. As a matter of fact, at least from a theoretical point of view, indemnity of litigation costs is a basic principle of Belgian civil procedure. From times immemorial, Article 1017 of the Belgian Code of Civil Procedure says that the party ruled against is ordered to pay the costs of trial. Attorney and expert costs were, and still are according to many, the big exception to this rule. In practice, they account for the largest part of litigation costs[21], but are not included in Article 1018 of the Belgian Code of Civil Procedure and have thus, as far as the letter of the law concerns, to be born by each party itself[22]. However, as explained in the introduction, the Supreme Court appears to have gradually extended the application of the basic principle of indemnity to attorney and expert costs.

 If follows from this overview that cost shifting need not be a matter of black or white. Costs can be shifted in one area of civil law, but born by each party itself in another. Furthermore, an indemnity rule's scope can be limited to certain litigation costs or a certain amount. Its application can also be made conditional, for instance on the unmeritoriousness of a claim[23]. And last but not least, a cost-shifting rule may apply unilaterally in favor of one of the disputants.

 For the purpose of analyzing the essential effects of cost shifting on the accessibility of justice, however, in this chapter, the simplest cost-shifting rule one can image is taken as a starting point: a rule according to which the prevailing party recovers unconditionally all litigation costs from the unsuccessful party. This rule is referred to as the *English rule* since litigation costs are commonly shifted in England. If each party bears his own expenses, hereafter, this is referred to as the *American rule*.

II.1.   Greater Trial Expenditures

A preponderant effect of cost shifting is that it leads parties to incur greater litigation costs (*greater expenditures effect*). Recall that from a party's viewpoint, trial expenditure is optimal

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[21] For an empirical study of the costs of civil litigation in Australia, see Williams and Williams (1994).

[22] However, the *rechtsplegingsvergoeding* ('indemnity for legal proceedings') in Article 1018 of the Belgian Code of Civil Procedure is meant to cover the costs of material acts performed by lawyers. As we speak, the basic tariff of this compensation does not exceed the amount of €50.

[23] Courts have interpreted US Federal Rule of Civil Procedure 11 as an example of such a rule. For an economic analysis of Rule 11, see Bebchuk and Chang (1996).

where its marginal cost equals its marginal benefit[24]. It is generally accepted, that the private optimal level of trial expenditure is higher under the English rule because of two reasons[25]. First, the stakes of trail are higher as the court judgment also applies to the parties' litigation costs. Therefore, cost shifting increases the marginal benefit of an additional investment in litigation. The marginal cost, on the other hand, is lower under the English rule as each litigant only expects to bear his legal expenses insofar as he loses at trial.

Such as most of the effects discussed in this chapter, also the greater expenditures effect has been empirically verified using data collected from the State of Florida's adoption of a cost-shifting rule during the period 1980-85 in an effort to restrain the growth in medical malpractice litigation[26]. In accordance with the above analysis, Snyder and Hughes (1990:374) found that the English rule leads to an increase in defense expenditures of 108 pct and 150 pct for respectively litigated and settled claims.

It should be noted, that in practice, restrictions on the recovery of litigation costs mitigate this greater expenditures effect. In England, cost awards are limited to a reasonable level[27]. In Germany, the *Bundesrechtsanwaltsgebührenordnung* (BRAGO), the system of attorney fee regulation, is binding for cost-shifting purposes[28].

II.2.   Level of Suit, Settlement and Adjudication – Claim Selection

II.2.1. Level of Suit

II.2.1.1. Positive and Negative Effects

The effects of the English rule on the level of suit can be best explained taking those conditions as a starting point in which the applicable cost-allocation rule doesn't matter. That is when, first, the plaintiff thinks he has a fifty-fifty chance of prevailing at trial, second, both parties are expected to spend the same amount on litigation, third, the English rule does not lead to greater trial expenditures, and fourth, the plaintiff is risk-neutral. If these four conditions are met, a claim's expected value is equal under either cost-allocation rule[29].

If now one of these four conditions is relaxed, it's quite straightforward to see how this affects the decision to file suit. If the plaintiff thinks he has a better than even chance of success, under the American rule, he still expects to bear his own expenses. Under the English rule, however, he expects most of the time to recover his own expenses while he only expects to bear the defendant's a minority of times. Hence, the English rule increases a claim's expected value along with the probability of suit[30]. Obviously, the opposite is true if the plaintiff is pessimistic about his prospects at trial.

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[24] See *supra* section I.1, final stage of the economic dispute resolution model.
[25] Braeutigam et al. (1984) at 180-81; Hause (1989) at 166; Katz (1987) at 159-61.
[26] For a comprehensive overview of the empirical literature on cost shifting, see Kritzer (2002) at 1946-61.
[27] Hughes and Snyder (1998) at 51.
[28] Kilian (2003) at 42.
[29] See also Snyder and Hughes (1990) at 349.
[30] Shavell (1982) at 59-60.

Differences between the parties' expenditure on litigation may either reinforce or weaken the abovementioned effects. If all other conditions are met and the plaintiff expects to outspend the defendant, the plaintiff is more likely to bring suit under the English rule. For then the plaintiff expects to bear half of both parties' legal cost, which is by definition less than his own expenses he has to pay under the American rule[31]. Conversely, the opposite is true if the plaintiff expects to be the one outspended. It should be noted that limitations on cost awards constrain the parties' ability to use this effect for strategic purposes by threatening to incur large legal costs[32].

All other things being equal, the English rule's increased expenditures effect lowers a claim's expected value and thus discourages the filing of claims relative to the American rule[33].

Finally, if risk aversion[34], the most common attitude towards risk, is introduced into the analysis, we first should note that the general effect of the plaintiff's risk aversion is to reduce the likelihood of suit, for engaging in a lawsuit involves uncertainty and thus costs of risk[35]. The English rule exaggerates this effect. For relative to the American rule, the variability in the plaintiff's position as between prevailing at trial or not is greater, as it also includes both parties' litigation costs[36]. The greater expenditures effect further aggravates this effect.

As the afore-mentioned effects are contingent on various factors (e.g., initial distribution of claim quality, plaintiff-to-defendant expected litigation cost ratio, magnitude of the greater expenditures effect, etc.), it's theoretically impossible to determine the ultimate effect of the English rule on the level of suit. What is, however, possible, is to derive certain conclusions as to the average quality of the claims that will be pursued under either cost-allocation rule.

II.2.1.2. Claim Selection

Indemnity of litigation costs encourages, by means of the first of the above effects, the filing of high-merit claims. Under the American rule, what counts is that the expected judgment is sufficiently large to offset the plaintiff's litigation costs. As a result, even an entirely legitimate claim with a 100 pct probability of success may have a negative expected value. Under the English rule, the probability of success is also the probability that the plaintiff doesn't bear any litigation costs, and is therefore particularly decisive to the decision whether to pursue a claim or not. Provided that the chances of success are sufficiently high the possibly low potential award is of practically no account under the English rule[37]. However, it

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[31] Hause (1989) at 167-68; Snyder and Hughes (1990) at 349.

[32] Snyder and Hughes (1990) at 349n11.

[33] Hause (1989) at 167-68; Snyder and Hughes (1990) at 351-52.

[34] For a risk-averse person uncertainty itself is undesirable. Whereas a risk-neutral person only cares about the expected value (see *supra* note 10), a risk-averse person also cares about the uncertainty it involves. For the remainder of the analysis, it's important to understand that the higher the variability of the possible payoffs, the higher the degree of uncertainty is, and the more a risk-averse person is willing to pay to reduce or eliminate the uncertainty involved (risk-premium).

[35] Shavell (1982) at 61.

[36] *Id.* at 62.

[37] Shavell (1982) at 59; Rosenberg and Shavell (1985) at 5-6.

follows from the analysis in the previous section, that small but strong claims will not be encouraged relative to the American rule, if the plaintiff expects to be outspended at trial by the defendant to a sufficiently large extent. Also, the greater expenditures effect and increased cost of risk may keep small but strong claims from being promoted by the English rule[38].

Conversely, cost shifting discourages the filing of weak claims. Insofar as the probability of success is sufficiently low, this includes claims with a relatively high potential award[39]. This effect is aggravated by the greater expenditures effect, the increased cost of risk, and even further insofar as the defendant is expected to outspend the plaintiff at trail[40].

Inherent to the English rule is thus a selection effect, that in principle promotes the filing of strong claims, even if they have a relatively low potential award, and discourages the filing of weak claims, even if they have a relatively high potential award. But as the increased litigation risk, the greater expenditures effect and/or the defendant's outspending rises, the plaintiff will apply a higher probability of success and/or potential award threshold below which he won't file any claim. This may lead him to file only highly meritorious claims with a high potential award[41].

This selection effect knows some restrictions. First, it won't prevent plaintiffs of low wealth from filing weak claims as they cannot afford – and thus won't fear – paying the opposing party's litigation costs (judgment proofness)[42]. Second, it's based on subjective quality measures, as it essentially relies on claim quality as perceived by the plaintiff. However, as he might be held liable for the defendant's litigation costs, under the English rule, the plaintiff has the rational incentive to screen claims more carefully[43]. Also, the 8.2 pct increase of the probability of a plaintiff win found by Hughes and Snyder (1995:238) is consistent with a selection effect based on 'objective' legal quality being inherent to cost shifting[44].

II.2.2. Level of Adjudication

To determine the ultimate effect of the English rule on the level of adjudication, first its effect on the rate at which claims are respectively dropped and settled should be analyzed.

II.2.2.1. Drop Rate

Both the decisions to bring suit and to drop a claim are taken on the basis of one and the same criterion: a claim's expected value. Consequentially, the effects of the English rule at both stages of the dispute resolution model are the same. However, whether and to what extent the English rule will have a systematic effect on the drop rate depends on two factors.

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[38] Hause (1989) at 167-68; Snyder and Hughes (1990) at 349-52.
[39] Shavell (1982) at 59; Rosenberg and Shavell (1985) at 5-6.
[40] Snyder and Hughes (1990) at 349-52.
[41] See also *id.* at 349.
[42] This was empirically observed in the Alaska's Rule 82 Study, see Di Pietro et al. (1995) at 101.
[43] Mause (1969) at 32.
[44] 'Objective' as perceived by judges and juries.

First, how good an estimation has been made of all relevant information at the time the claim was brought, thereby taking into account the applicable cost-allocation rule. This is important as weak claims that haven't been brought under the English rule, can't be dropped anymore at a latter stage.

Second, insofar as the cost-allocation rule has systemically been taken into account at the filing stage, the effect at the drop stage further depends on the nature of the information which becomes available after suit was brought, and more in particular, how this information relates to the effects of the English rule on a claim's expected value. New information on the defendant's trial expenditures may either increase (he is expected to spend more than initially was assumed) or decrease (he is expected to spend less) the plaintiff's expected litigation costs along with the likelihood that a claim is dropped relative to the American rule. As it is impossible to know what type of information will become available after suit was brought, it's in this case theoretically impossible to determine the ultimate effect the English rule will have on the drop rate[45].

In the alternative case, if the English rule was not systematically taken into account at the filing stage, the theory applicable to the filing decision applies also to the decision to drop a claim.

Snyder and Hughes (1990:364) found that the English rule increases the drop rate by 10.4 pct. They explain the magnitude of the effect by the fact that given low filing costs, plaintiffs file suit without carefully ascertaining its quality, but with the purpose of collecting further information[46]. Consistent with the alternative hypothesis of our theory, the actual claim selection rather occurs at the drop than at the filing stage, where, as a result, the English rule has most of its effect. The ultimate effect itself, a 10.4 pct decrease in drop rate, is consistent with the specific claim selection hypothesis we've developed above[47], according to which the greater expenditures effect, the increased litigation risk and/or the defendant's outspending lead the plaintiff to only continue claims which combine a high probability of success with a relatively large potential award. Clearly, the determent of weak claims by the English rule is far from compensated by the promotion of strong but small claims. In Hughes and Snyder (1995) both scholars have further extended the empirical evidence in support of this hypothesis.

II.2.2.2. Settlement Rate

The various effects of the English rule on parties' settlement behavior do not point uniformly in one consistent direction. Therefore, it's theoretically impossible to determine its ultimate effect on the settlement rate.

First, recall that the settlement surplus equals the sum of both parties' litigation costs minus the amount by which the plaintiff's estimate of the expected judgment exceeds the

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[45] *Contra* Snyder and Hughes (1990) at 376n48 (apparently not taking account of the positive effects the English rule may have on a claim's expected value).
[46] Snyder and Hughes (1990) at 377.
[47] See *supra* text accompanying note 41.

defendant's[48]. We also already know that the English rule induces parties to incur greater litigation costs. It follows thus that by means of the greater expenditures effect the English rule tends to increase the settlement surplus along with the likelihood of settlement. The intuition behind this is that settlement becomes more attractive as it offers the parties the option to eliminate any possibility that they have to bear the increased costs of trial[49]. In addition, the English rule encourages risk-averse parties more to settle, as cost shifting increases the uncertainty of proceeding to trial[50].

On the other hand, the English rule also tends to discourage settlement as it's conducive to the 'relative optimism effect'[51]. Parties are – and do have the tendency in real life to be[52] – relatively optimistic if the plaintiff beliefs he has a better chance of winning than the defendant thinks is correct. As we've assumed the potential award to be estimated alike by both parties[53], this effect increases the amount by which the plaintiff's estimate of the expected judgment exceeds the defendant's – the other component of the settlement surplus. This way relative optimism reduces the settlement surplus and thereby the probability of settlement. Cost shifting magnifies this effect by making the parties' litigation costs subject to the court judgment, and thus also to any difference in opinion between the parties as to the plaintiff's prospects at trial. The greater expenditures effect aggravates this tendency towards litigation by increasing the stakes at trial even further.

Correcting for non-random selection effects, Snyder and Hughes (1990:366) estimated that the English rule decreases the settlement probability by 9.6 pct. This is consistent with the aggravation of the relative optimism effect being dominant.

II.2.2.3. Eventual Level of Adjudication

From the above, both theoretical and empirical, analysis it's impossible to derive the ultimate effect of the English rule on the eventual level of adjudication. Empirically, Snyder and Hughes (1990:364) found that cost shifting decreases the probability that any filed claim is adjudicated by 5 pct. As we already know that the effect of the English rule on the parties' settlement *behavior* accounts for an estimated 9.6 pct increase in litigation probability, it follows that the ultimate decrease of the adjudication rate is the result of a changed *selection* of claims reaching the settle-versus-litigate stage. More in particular, correcting for behavioral effects, the English rule increases the settlement probability of a claim not dropped by 16.6 pct[54]. It appears thus that under a cost-shifting rule plaintiffs are more likely to drop claims that otherwise would have been litigated[55]. Also this can be seen as empirical evidence of the selection effect we've attributed to the English rule. For claims that would've been litigated

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[48] See *supra* text accompanying note 15.
[49] Bowles (1987) at 177-81; Hause (1989) at 167.
[50] Shavell (1982) at 68. See also *supra* text accompanying note 36.
[51] Shavell (1982) at 65-66; Katz (1987) at 157-59.
[52] See the empirical study by Loewenstein et al. (1993).
[53] See *supra* section I.2, claim quality.
[54] Snyder and Hughes (1990) at 366.
[55] *Id.* at 365, 376-77.

under the English rule are likely to be weak, as these claims don't have much chance of being settled – the defendant wouldn't fear trial since he has a high chance of prevailing and thereby of recovering litigation costs.

II.3.   Duration of Claims

II.3.1. Dropped Claims

A claim that turns out relatively weak, will be dropped at the point in time where its expected value falls below zero. This proposition holds irrespective of the applicable cost-allocation rule. What does, however, vary with the applicable cost-allocation rule, is the rate at which a claim's expected value falls over time. Under the American rule, information on the lower than initially estimated expected probability of success only decreases the expected judgment, while under the English rule, it also increases the plaintiff's expected litigation costs. Consequentially, as step by step a claim's relative weakness is revealed to the plaintiff, each step the claim's expected value is affected more badly under the English rule. As a result, a weak claim's expected value falls faster under the English rule, which therefore induces plaintiffs to drop their claim rather sooner than later relative to the American rule[56].

This hypothesis has been empirically confirmed by Hughes and Savoca (1997:269).

II.3.2. Settled Claims

Hughes and Savoca (1997:269) also found that the English rule shortens duration of settled claims. This result can be explained as follows. As we've demonstrated above, under the English rule the plaintiff is more likely to proceed to the settle-versus-litigate stage with claims of which he thinks have a high probability of success[57]. Further, the fact of settlement indicates that the parties were not relatively optimistic to a prohibitively large extent. Obviously, the defendant agreed to a certain extent on the plaintiff's prospects at trial. This implies that he was aware of the relative weakness of his threat to go to trial. The plaintiff, on the other hand, will be less hesitant to proceed to trial and to incur large legal costs in course of that. Convinced of the strength of his case, he knows that insofar the defendant is not willing to reimburse his legal costs as part of a settlement, he is very likely to recoup these costs if he pursues the claim to judgment. Therefore, there is only one rational strategy the defendant can follow under the English rule, and that is, to settle the case as fast as possible. Otherwise, he will have to pay additionally for the plaintiff's pretrial c.q. trial expenditures, either as part of a late settlement or at trial[58]. Insofar as a weak claim reaches the settle-versus-litigate stage and is settled, the same reasoning applies to the plaintiff[59].

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[56] *Cf.* Hughes and Savoca (1997) at 264-65 (reaching a similar conclusion but on different grounds).
[57] See *supra* text accompanying notes 47 and 55.
[58] See also Hughes and Savoca (1997) at 264-65.
[59] Bouckaert and De Mot (2005) at 303-04.

II.3.3. Adjudicated Claims

Finally, on theoretical grounds one may expect the English rule to lengthen the duration of adjudicated claims. At least, insofar as the greater expenditures parties tend to make under the English rule result in more extensive and time-consuming trial proceedings. Arguing that the fear of being held liable for both parties' litigation costs will reduce the incentive to engage in costly, dilatory tactics[60], doesn't seem convincing in light of the foregoing analysis. If one or both parties wouldn't feel comfortable about his chances at trial, more than under the American rule, the plaintiff would've been induced to drop his claim and the defendant to settle. Obviously being relatively optimistic, both parties ended up in court where they rather expect the opposing party to bears the costs of trial[61].

However, in the research by Hughes and Savoca (1997:269) the English rule didn't show any statistical significant influence on the duration of litigated claims.

III.   Fee Arrangements

Thus far, attorneys were exogenous to our model. In reality, however, disputants commonly lack the required degree of knowledge and skill to effectively assert and defend their rights. Therefore they typically hire a lawyer to handle their case. Usually lawyer fees account for the greater part of the costs of pursuing a legal claim[62]. Attorney costs are thus at the core of the financial barrier to civil justice. On the other hand, that same observation points at the prospects the plaintiff-lawyer relationship might hold for bridging the funding gap.

Today the predominant form of payment for legal services in Belgium is at an agreed hourly rate[63]. In the alternative, lawyers are paid a fee according to the value of the matter in controversy or, mostly in files that are not of contentious nature, a lump-sum amount. Although legal fees may vary with several criteria, among which the result obtained, fees only depending on the outcome of the case are prohibited by Article 459 of the Belgian Code of Civil Procedure. This implies that plaintiffs are liable for attorney costs regardless of the outcome of the case, thus also when no (sufficient) award has been collected to cover costs. Furthermore, often clients are required to pay legal fees upfront or as the case progresses.

This contrasts sharply with US legal practice, where attorneys are allowed to take cases on a contingency fee basis[64]. In a contingency fee arrangement a lawyer agrees to a reward that varies with the outcome of the case in a two folded way. First, if the case is lost, the lawyer receives no compensation ('*no cure, no pay*'). Second, if – and thus after – the case is settled or won, the lawyer gets a prefixed percentage of the award obtained.

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[60] Kuenzel (1963) at 80.

[61] Hughes and Savoca (1997) at 265.

[62] See, e.g., the empirical study by Williams and Williams (1994) at 79, 81-83.

[63] This is according to the information provided by the Belgian local bar associations and law firms. See, e.g., <http://www.advocaat.be>, <http://www.avocat.be>, <http://www.elegis.be/page.asp?id=1881&langue=EN>.

[64] For a European perspective on US contingency fee arrangements, see De Vaan (2002).

In Europe, these 'extreme' forms of performance pay are viewed with great skepticism. No European lawyer is allowed to make a contingency fee arrangement[65]. However, lately there are increasingly more signs that the traditional European resistance against outcome-based remuneration is weakening. England and Wales, for example, have adopted conditional fees in 1995[66] and in the Netherlands, contingency fees are highly debated since in February 2002 antitrust law was successfully deployed against the no cure, no pay-prohibition in the lawyer's code of conduct[67]. These recent developments are suggestive of the future relevance of the analysis provided in this chapter, which aims at highlighting how the introduction of contingency fee arrangements in an hourly fee system is likely to affect the accessibility of civil justice.

In addition to the standard economic dispute resolution model, the analysis builds on principal-agent theory: the body of economic theory that treats the problems that arise when a principal hires an agent to act on his behalf under the dual condition of asymmetric information and potential conflict of interest[68]. Both conditions are typical to the everyday client-lawyer relationship. Recall that a lawyer's better skill and knowledge of legal matters is the typical motivation for a client to hire a lawyer in the first place. Moreover, high monitoring costs are likely to prevent a client from being fully informed about his lawyer's performance[69]. Also a potential conflict of interest is inherent to the typical client-lawyer relationship, as a lawyer's interest in a case is in the fee he can earn[70], while for his client the outcome is what matters. As will turn out below, fee arrangements have been found to be a response to any one or combination of the typical agency problems that arise under these conditions[71].

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[65] Article 3.3 of the CCBE-Code of Conduct for Lawyers in the European Union.

[66] A conditional fee arrangement combines no cure, no pay with an up lift of up to 100 pct over the normal fee if the case is successful. For an overview of the relevant economic literature, see Emons (2006) at 23-24.

[67] NMa, Case 560/87, *Engelgeer*, February 21, 2002 available at <http://www.nmanet.nl>. No cure, no pay was until recently subject of discussion in the Commission on the legal profession, see Commissie Van Wijmen (2006). For a first criticism on the final report, in particular on the little weight it attaches to law and economics arguments, see Van Almelo (2006).

[68] The terminology used here refers not to the legal concept of representation, but to a much broader concept of 'agency relationships' developed in economic theory, see the seminal work by Jensen and Meckling (1976).

[69] Asymmetrical information can also exist in the opposite direction, as the client is typically better informed on the facts underlying the case. This implies that both the lawyer and his client can act as each other's agent ('dual agency'), see Miller (1987). On the role fee arrangements can play in this respect, see Rubinfeld and Scotchmer (1993). The present analysis, however, abstracts from this possibility and assumes only imperfect information at the client's side as to claim quality and lawyer performance.

[70] As is reflected in the traditional arguments against contingency fee agreements (e.g., they would increase the incentive for lawyers to provide advice which isn't in the client's best interest) this is not only consistent with the rationality assumption underlying the analysis, but also with real life, see Gravelle (1998) at 383.

[71] See also Rubinfeld and Scotchmer (1998) at 417.

III.1.   Level of Suit, Settlement and Adjudication – Claim Selection

III.1.1. Level of Suit

One of the arguments traditionally put forward against contingency fees is that they would stimulate 'excessive' litigation. Other terminology, such as 'speculative' and 'frivolous' litigation, is commonly used in this respect as well[72]. This is suggestive of the confusion these allegations are surrounded by. One should make a clear distinction between two different issues. On one hand, there is the fact that contingency fees may lead to an overall increase in the level of suit. On the other hand, there is the issue of claim quality, and how this is affected by contingency fee agreements.

III.1.1.1. Positive Effects

Insofar as by 'excessive' is meant that contingency fees may lead to an overall increase in the level of suit, several arguments in support of this claim can be brought forward.

First, contingency fee agreements can be used to finance the attorney costs of pursuing a claim. As contingent fees are only collected after the case is closed, they allow a plaintiff in fact to borrow money from his lawyer while the case is pending. When capital markets are imperfect, this may allow liquidity constrained plaintiffs to bring suit where they otherwise wouldn't have been able do so, insofar as they can't afford the upfront payment of an hourly lawyer[73].

Second, a contingency fee arrangement essentially incorporates an insurance policy, as it shifts the risk of not obtaining a sufficient award to cover attorney costs from the plaintiff to his lawyer. Insofar as the plaintiff is risk-averse, he will bear less costs of risk and is thus more likely to bring suit[74]. Also, the overall cost of risk born by the plaintiff and his lawyer will be lower, as lawyers can diversify their portfolio of cases, which is very likely to make them less risk-averse than their clients[75]. Since an hourly fee arrangement allocates both the entire cost and proceed risk to the client, it does not allow for these risk-sharing benefits to be produced[76].

Although these effects have all a positive influence on the level of suit, they are no sufficient ground to conclude that the introduction of contingency fees would lead to an overall increase in the level of suit. If there is no excess capacity in the market for legal services, the opposite may occur. For some cases that would've been taken before on an hourly fee basis may be replaced in lawyers' portfolios by cases that on a contingent fee basis are more lucrative. Insofar as more time is spent on these new cases than on the hourly fee

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[72] See, e.g., Olson (1991), Bernstein (1996).
[73] Rhein (1982) at 155-56; Shrager (1985).
[74] Posner (1986) at 534.
[75] See Gravelle (1998) at 383.
[76] For a more extensive analysis, see *id*.

cases before[77], this will reduce the number of cases that can be handled in a same period of time along with the level of suit, at least in the short run. However, as it is generally accepted that there is an oversupply of legal services, this is not likely to occur in Belgium.

It should be noted that the magnitude of the ultimate effect essentially depends on the contingency percentage lawyers work for[78]. As a contingent fee, in principle[79], only covers attorney costs, it follows from the economic dispute resolution model that a plaintiff will only bring suit if his share in the expected judgment exceeds the remaining expected litigation costs. Not only the plaintiff's share, but also the expected judgment itself varies with the agreed contingency percentage, as this affects the effort a lawyer devotes to a case[80].

III.1.1.2. Claim Selection

At first sight, the economic dispute resolution model seems to confirm the common allegation that contingency fees encourage meritless litigation. Consider the cost-benefit calculus a plaintiff with an unmeritorious claim faces: insofar as the case would be successful, he expects a positive payoff equal to his share in the joint winnings; if the case is lost, he doesn't expect any payoff, neither positive nor negative[81]. If follows that even the smallest chance of success is sufficient for a plaintiff to make it worthwhile to bring suit under a contingent fee agreement. Thus one would indeed expect that if contingency fees were allowed the judicial system would be overrun by unmeritorious lawsuits, but for one crucial aspect we've been neglecting up to now: 'it takes two to dance the tango'.

The key question is whether a contingency lawyer would accept the type of cases at hand. There seems little to no reason to answer this question positively. As a contingency lawyer has a direct financial stake in the outcome of the case, he will rationally decline weak claims. Given their low probability of success, he won't expect them to have a sufficiently high return to cover the opportunity cost of his time[82]. That is, not only the plaintiff's, but also his lawyer's expected value of the case need be positive. The better expertise lawyers typically possess pleads in defense of contingency fees as well. Together with part of the litigation risk, a contingency fee agreement shifts the primary screening function to the lawyer, who will do a much more effective job than his client[83]. This selection effect has been empirically verified by Kritzer (1997:26-28), who confirms the role of contingency lawyers as gatekeepers in the civil justice system: generally they turn down at least as many cases as they accept, more often because potential clients do not have a basis for their case (i.e. low legal quality). Not

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[77] It is not unrealistic that more time would be spent on contingency fee cases: Kritzer et al. (1985:267) found for cases above $30,000 that if there would've been any significant difference between the hours spent on a case, it was that contingency lawyers put in more time than lawyers paid an hourly fee.

[78] See *infra* text subsequent to note 98.

[79] Kritzer (1998a:270), however, notes that while in many US states clients are liable for expenses regardless of the outcome of a case, the reality is that lawyers who pursue a case unsuccessfully on a contingency fee basis seldom collect those expenses or even seek to collect them.

[80] See *infra* text accompanying notes 95 and 96.

[81] For sake of the argument, we abstract from all other litigation costs, except for legal fees.

[82] Dana and Spier (1993) at 349-50. See also Miceli (1994).

[83] Clermont and Currivan (1987) at 571-72.

surprisingly, however, also lack of adequate damages (i.e. low potential award) accounts for a smaller proportion of cases declined.

These findings redirect attention to the question how the prospect of an hourly fee affects a lawyer's incentive to screen cases. This caused Helland and Tabarrok (2003:529-36) to examine whether legal quality is lower under contingency or hourly fees. Their empirical findings confirm what the foregoing analysis implicitly suggests: hourly lawyers have less of an incentive than contingency lawyers to give plaintiffs unbiased assessments of the quality of their claim[84]. As a matter of fact, concerns for reputation aside, since an hourly lawyer's reward is not contingent on the outcome of the case, it would be no more than rational for him to pursue a frivolous claim when he has uncommitted time[85]. For this way he can charge for time that would otherwise produce no income.

A defendant doesn't have to select claims; he has no choice but to defend himself when sued. Therefore an hourly lawyer's skewed incentives in this respect generate probably fewer distortions at the defendant's than at the plaintiff's side. This could explain why contingent fee agreements are rarely used by defendants[86].

III.1.2. Level of Adjudication

III.1.2.1. Drop Rate

It follows from the previous discussion, that an hourly lawyer has little financial incentive to advise his client on the low expected value of what has appeared a low-quality claim. A contingency lawyer, on the other hand, will screen the information that has become available after suit was brought more carefully, and only continue cases that have a sufficiently high expected return[87,88]. As a result we expect more claims to be dropped by a contingency lawyer, than on the advice of an hourly lawyer (*screening effect*).

However, it should also be taken into account that under hourly fees the selection of claims reaching the drop stage is likely to be of lower average quality. As we've discussed before, an hourly lawyer has also a weaker incentive to screen claims at the filing stage and will thus let more low-quality claims proceed to the drop stage. While we don't expect him to inform his client on this low quality at the drop stage either, it's not unrealistic that some of these low-

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[84] Dana and Spier (1993).

[85] Uncommitted time also affects a contingency lawyer's incentives: it decreases the opportunity cost of his time, so he will accept cases with a lower expected value. But as he gets only rewarded a percentage of the recovery, he will invest time in more low potential award claims and/or complex but meritorious cases that require more work, rather than in meritless claims that have almost no chance of recovery. This is also observed in practice, see De Vaan (2002).

[86] Dana and Spier (1993) at 351. In line with common practice and for simplicity, below, the defendant's attorney is assumed to work on an hourly fee basis.

[87] When a contingency lawyer decides to no longer pursue a claim, we consider this also a dropped contingency fee claim; thereafter, the claim may be either entirely dropped or the plaintiff may proceed on an hourly fee basis.

[88] Generally US attorneys may withdraw for any reason, but only when a withdrawal over a client's objection has a justifiable cause legal fees are entitled. Nor the good faith belief that a case is meritless, neither the finding that it's more complex or requires more time than initially was estimated, constitutes a justifiable cause, see De Vaan (2002). See also Becker (2004) (California law).

quality claims will be dropped unilaterally by the client. He will do so when, after getting to know more about his case as the dispute resolution process advances, at a certain point in time he finds out that his claim has actually a negative expected value. Given the average lower quality of filed claims, this is much more likely to be the case for claims brought under an hourly fee (*selection effect*)[89].

Which of both effects dominates the other is theoretically unclear.

Empirical evidence suggests that the selection effect outweighs the screening effect. Danzon and Lillard (1983:363) found that contingency fee limits increase the drop rate by 5 pct[90].

III.1.2.2. Settlement Rate

According to a first generation of models, a claim handled on a contingency fee basis is more likely to settle[91]. The usual explanation is that by settling a claim, a contingency lawyer secures his share of the settlement amount without having to invest the additional time that would be required if the case were to go to court. Therefore, he will advise[92] his client to ask a settlement amount that is too low relative to the client's interest[93], as this increases the settlement surplus and thus the likelihood of settlement. On the other hand, relative to a contingency lawyer, an hourly lawyer will advise a higher settlement demand: if he's neutral toward settlement, he will advise the optimal amount; while if he has uncommitted time, he will be induced to discourage settlement by advising a too high amount so he can spend more billable hours on the case at trial.

A second generation of models, however, demonstrates that contingency fees may also create incentives for lawyers to settle cases less often, and for a higher amount than would be optimal for the plaintiff[94]. The contribution of Polinsky and Rubinfeld (2002) in this respect appears most influential, as it shows that the conventional analysis fails to incorporate the effect fee arrangements have on attorney effort. Contrary to what first generation models assume, contingency lawyers spend rather too little than the optimal amount of time on a case. The well-know explanation therefor is that under a contingent fee contract, a lawyer bears the full cost of his time, but obtains only a fraction of the benefits. Therefore, the level of effort that equates his marginal cost and marginal benefit is lower than the level that would maximize the claim's expected value[95]. Only when a contingency lawyer internalizes the entire benefit of his investment he will behave optimal, that is, when his contingency

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[89] This is the hypothesis underlying the empirical strategy adopted by Helland and Tabarrok (2003:521).

[90] It remains unclear whether Helland and Tabarrok (2003) were able – or at least tried – to correct for the screening effect. No doubt they were familiar with the effect, see *id.* at 522n7 (discussing Dana and Spier (1993)).

[91] Schwartz and Mitchell (1970), Miller (1987), Thomason (1991), Gravelle and Waterson (1993).

[92] In an attempt to correct for potential conflicts of interest, the law usually gives settlement authority to the client, see Miller (1987) at 190.

[93] The optimal (settlement) amount from the plaintiff's perspective is the amount that would be chosen by a *perfectly knowledgeable plaintiff* – one who doesn't face any asymmetrical information, neither as to legal matters, nor as to lawyer performance – who pays his lawyer by the hour.

[94] Miceli (1994), Bebchuk and Guzman (1996), Rickman (1999), Polinsky and Rubinfeld (2002).

[95] Schwartz and Mitchell (1970) at 1135-36. See, however, Danzon (1983) (showing that under certain specific conditions contingency lawyers' effort incentives are optimal).

percentage is no less than 100 pct[96]. Once this is taken into account, as Polinsky and Rubinfeld (2002:222-224) demonstrate, it may be rational for a contingency lawyer's settlement demand to be higher than would be optimal, resulting in too little settlements occurring.

Empirical evidence seems only to confirm Polinsky and Rubinfeld (2002) and the other second generation models in their approach. Danzon and Lillard (1983:363) found that contingency fee limits decrease settlement amounts by 9 pct and increase the settlement rate by 1.5 pct. Also Snyder and Hughes (1990:366) found that contingency fee limits encourage the parties to settle their dispute. This could be explained as if contingency lawyers have on average an even stronger incentive than their hourly fee counterparts to raise settlement demand, thus reducing settlement probability.

III.1.2.3. Eventual Level of Adjudication

Due to hourly lawyers' weaker incentives to screen cases for their true quality at the filling stage, the drop rate of claims handled on an hourly fee basis is higher. Also, the number of settled claims was found to be higher for hourly fee cases. As a result, claims brought under an hourly fee are less likely to be adjudicated. Consistent herewith, Snyder and Hughes (1990:360) found that contingency fee limits reduce the probability that a filed claim proceeds to adjudication.

III.2. Attorney Costs

Fee setting may affect a plaintiff's attorney costs as well as the overall price level in the market for legal services. Further, the susceptibility of attorney costs for lawyer opportunism varies with the applicable fee arrangement. Below, each of these effects of contingency fees on attorney costs is examined, both from a lawyer's and plaintiff's perspective.

III.2.1. Lawyer's Perspective

Given the additional, costly finance and insurance services a contingency lawyer provides, he will rationally demand to do better on average than his hourly fee counterparts[97]. This is also observed in practice. Contingency fees yield higher average effective hourly rates (the per hour return for the time a lawyer devotes to a case) than hourly fees[98].

Further, the nature of competition will determine the price at which contingency lawyers sell their services. This is apparent from the comparison of Schwartz and Mitchell (1970) and Danzon (1983). Both assume risk-neutrality and perfect competition, but where in the former

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[96] This is why, if attorney effort is entirely unobservable, a fee arrangement in which the attorney buys the rights to the client's legal claim would be most optimal. Such a fee arrangement is, however, prohibited in most US states. See further Santore and Viard (2001).

[97] By "hourly fee counterparts" here is meant lawyers with the same quality, experience, etc. but who are paid at an hourly rate. *Cf.* Kritzer (1998a) at 272.

[98] Not everyone agrees, however, on *how much* better contingency lawyers do in practice, see *infra* text accompanying notes 115 and 116.

lawyers compete for cases by bidding down on the contingency percentage, the latter assumes competition on the basis of the client's net recovery. As a result, their conclusions as to the equilibrium attorney effort and expected fee differ. Danzon (1983:216) finds equilibrium outcomes identical to those that would appear if lawyers were hired at an hourly rate by perfectly knowledgeable clients. Schwartz and Mitchell (1970:1138-39) arrive at fewer hours per case, lower gross recoveries and lower fees.

As these models rely on fairly unrealistic competitive requirements, the question arises which part contingency fees can take in the approximation of the market for legal services to the ideal of perfect competition. A prerequisite for competition to flourish is that in addition to the price, consumers are also able to determine the relative quality levels so they can make informed price/quality trade-offs[99]. However, legal quality is to a large extent a credence good: asymmetrical information prevents most consumers from performing a reliable quality judgment even *after* legal services have been performed[100]. Reputation may provide some guidance, but this gives no more than a weak indication of the true quality of a lawyer[101]. Therefore, it's generally accepted that to avoid the overall deterioration of quality – 'the market for lemons'[102] – regulation is required to ensure a minimum quality standard of legal services[103]. On top of that standard, contingency fees can contribute to the transparency of the market for legal services by allowing high-quality lawyers to distinguish themselves from low-quality lawyers. As by their very nature contingency fees result *ceteris paribus* in higher returns to high-quality lawyers, the latter can compete for cases on the basis of their quality by bidding down on the contingency percentage[104]. Also, when both contingency and hourly fees are combined, a lawyer can credibly signal his quality by assuming more of the risk and letting more of his fee depend on the outcome of the case[105].

However, there is no guarantee that consumers will effectively associate a lower contingency percentage with a higher quality level. It's reasoned that consumers who are unable to assess quality may perceive a cut-rate price offer as signalling that more knowledgeable purchasers have assessed the lawyer as being of low quality[106]. A related reason why lawyers may be deterred from price undercutting is that insofar their performance is non-verifiable by clients, they will be expected to put less effort[107]. Indeed, if follows from what we've argued before, that the lower the contingency percentage, the less time a lawyer will devote to a case[108].

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[99] Brickman (2003a) at 93.
[100] On credence goods, see Darby and Karni (1973).
[101] Copenhagen Economics (2006) at 9.
[102] Ackerlof (1970).
[103] Stephen (2001) at 2.
[104] Kerkmeester (1999) at 260.
[105] Rubinfeld and Scotchmer (1993).
[106] Brickman (2003a) at 100-01; Council of Bars and Law Societies of Europe (2006) at 11 (citing Stephen (2004)).
[107] Brickman (2003a) at 100-01.
[108] See *supra* text accompanying notes 95 and 96.

III.2.2. Plaintiff's Perspective

That a contingency lawyer does better on average than an hourly lawyer, does not imply that all of his clients pay more for legal services than they might if they paid by the hour. Assuming one single contingency percentage, plaintiffs who obtain no recovery don't pay any legal fee, others bear some attorney costs, and finally clients who obtain a large recovery pay the largest fee. The latter are most likely to pay more than if they paid by the hour[109]. The difference constitutes, in principle, an interest and risk premium, which compensates the contingency lawyer for the additional finance and insurance services he provides[110]. However, the proportion of hourly to contingent fees in practice is much less straightforward, as they are both also determined by the extent to which the path is clear for lawyer opportunism.

III.2.2.1. Contingency Lawyer Opportunism

Clients generally have no way of knowing how strong a case they have, and that is exactly the reason why many choose to pay on a percentage basis. Kritzer (1998a:305) reports that clients almost always opt for a contingent fee when advised of even the slightest possibility of a downside risk. At once, this emphasizes the importance of contingency fees' risk-sharing properties, but also it reveals potential grounds for lawyer opportunism. In order to maximize his profits, a lawyer may overstate the risk of client non-recovery and recommend a contingent fee where given the client's financial position and true probability of winning, an hourly fee would've been in his best interest[111]. Further, a contingency percentage can be insisted on that is disproportionate to the actual degree of risk the representation involves[112]. Both grounds for opportunistic behavior underlie the set of binding and nonbinding rules imposed on US lawyers that aim at safeguarding the client's interest in fee negotiations[113]. The final piece to this regulation is the possibility to bring a fee's 'reasonableness' before the court, in course of which factors are taken into account such as the degree of asymmetric information and the actual risk of non-recovery at the time the fee arrangement was concluded[114].

However, at present time the effectiveness of this regulation and the reasonableness of contingency fees are in the eye of the US tort-and-judicial-reform storm. The actual degree of competition in the contingency fee market is inherent to this debate. Basically, there are two competing views. According to Kritzer (1998a) the returns to the contingency bar are at best "somewhat" better than what hourly lawyers earn; market-related mechanisms serve to bring down unreasonably high fees, and can be further enhanced by improving consumer awareness[115]. On the other hand, Brickman (2003b) argues that the yields of contingency

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[109] See also Kritzer (1998a) at 307.
[110] Brickman (1996) at 270.
[111] Kritzer (1998a) at 305.
[112] Halpern and Turnbull (1983) at 14.
[113] For an overview, see De Vaan (2002) (including references).
[114] *Id*.
[115] See also Galanter (1998), Silver (2002).

practice have become inordinately high and advocates a strict regulatory approach; he points at restrictions to price competition imposed by the bar and ethical rules that would allow lawyers to collusively maintain a uniform price[116]. The most important conclusion we can draw from this intense yet indecisive debate, is that the enhanced free market process we've attributed to contingency fees can[117], of course, also be stifled by other factors, which inhibit the emergence of a competitive market, such as excessive regulation of the legal profession. Sure, also the market for hourly fees is susceptible to it[118]. And most importantly, even if hourly fees would allow for competition under certain restrictive practices where contingency fees wouldn't[119], according to Brickman (2003a:106), the risk and agency costs clients face in an hourly fee setting are so extensive that they didn't allow hourly fees to compete with the allegedly overpriced US contingency fees.

III.2.2.2. Hourly Lawyer Opportunism

Indeed, also under an hourly fee arrangement clients encounter various agency problems which may affect attorney costs. As a matter of fact, only when he doesn't face any asymmetric information a client will be able to ensure that his hourly lawyer puts the optimal amount of effort[120]. However, lack of expertise typically prevents a client from judging the appropriateness of the hours a lawyer claims that should be devoted to a case. If he has uncommitted time, an hourly lawyer will have the rational incentive to make use of this information asymmetry and inflate the hours a case warrants, so he can charge for time that would otherwise produce no income[121]. Recall that a contingency lawyer has the opposite incentive and rather invests inadequate time in a case[122]. The difference is, however, only statistically discernable for cases involving up to $6,000[123].

   Furthermore, the additional time an hourly lawyer charges for does not guarantee a corresponding increase in expected award. Insofar as his performance is not accurately observable by the client, an hourly lawyer is induced to shirk and spend less time on a case than he bills for. Contingent fees can be used to address this moral hazard problem[124], at least to some extent[125]. Also his lack of direct financial interest in the resulted obtained affects the way an hourly lawyer allocates his time to a case relative to a contingency lawyer. Not surprisingly, Kritzer et al. (1985:270-71) found that the latter is much more sensitive to the potential productivity of his time and less affected by craft-oriented factors. *Ceteris paribus* a

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[116] See also Painter (1995), Hadfield (2000).

[117] We do not argue that this is actually the case in the US; that remains unclear.

[118] Indicative is the battle against restrictive and disproportionate regulation of liberal professions the European Commission has engaged since February 2004, see <http://ec.europa.eu/comm/competition/antitrust/legislation/prof.html>.

[119] A possible argument could be that the improved transparency contingency fees bring about, facilitates the maintenance of a tacit collusion as it allows for better control of the other market participants' behavior.

[120] See *supra* note 93.

[121] Halpern and Turnbull (1983) at 14.

[122] See *supra* text accompanying note 95.

[123] Kritzer et al. (1985) at 268.

[124] Danzon (1983), Gravelle and Waterson (1993), Polinsky and Rubinfeld (2003), Emons and Garoupa (2006).

[125] See *supra* text accompanying notes 95 and 96.

plaintiff who aims at maximizing his recovery appears better off with a contingent fee, while someone who wants also to pursue other-than-strictly-financial goals may be better served by an hourly lawyer.

III.3.   Duration of Claims

III.3.1. Dropped Claims

It follows from our discussion on the drop rate, that a contingency lawyer rather than his client pulls the strings on the decision to drop a claim. When handled on an hourly fee basis, a claim is rather dropped on the plaintiff's initiative. Both actors have the same incentive: they want to avoid spending resources on a case that is actually not worth it. However, their knowledge and skill to do an effective job in this respect differ. Typically the contingency lawyer will be much better in collecting, processing and evaluating relevant information. He will be capable of keeping track of the claims' expected value on a day-to-day basis, while it will take the plaintiff much longer to get to, and process the relevant information. Therefore, it will take on average longer for claims handled on an hourly fee basis to be dropped.

No empirical research is known to us that directly aims at measuring the impact of contingency fees on the duration of dropped claims. In course of their research on cost shifting, Hughes and Savoca (1997:271) also controlled for the effects of contingency fee limits on the longevity of dropped claims, but they didn't find any statistical significant effect, neither with regard to settled nor adjudicated claims.

III.3.2. Settled Claims

The incentive analysis we've made thus far doesn't leave much doubt about how an hourly lawyer will behave as to the timing of settlement. He can increase billable hours by spending more time round the negotiation table. Thus, insofar as the case actually gets settled and he has uncommitted time, he prefers it rather later than sooner. For a contingency lawyer time is definitely money[126]. Even if, as according to the second generation models[127], he may have an insufficient incentive to settle, a contingency lawyer won't engage in dilatory tactics as he can't earn any money from it. Therefore, cases handled on a contingency fee basis will take shorter to settle.

Helland and Tabarrok (2003:536-39) present empirical evidence in support of this claim.

III.3.3. Adjudicated Claims

Again, by spending more time on pre-trial and trial proceedings, an hourly lawyer can increase billing hours. A contingency lawyer, on the other hand, is as we know much more sensitive to his time and its productivity. Therefore, we expect an hourly lawyer to increase

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[126] Bernstein (1996).

[127] See *supra* text accompanying note 94.

the duration of adjudicated claims, for example, by calling more witnesses or asking for a second-opinion on an expert's report where a contingency lawyer wouldn't do so. However, as the effect of fee arrangements on lawyers' incentives to spend time on a case was only found statistically discernable for cases involving up to $6,000[128], the difference in duration between claims handled on a contingency and hourly fee basis may fade away – if not reverse[129] – as the stakes become higher.

Except for Hughes and Savoca (1997)[130] we know of no other empirical study that has searched for effects of fee arrangements on the duration of adjudicated claims.

IV.   Legal Expenses Insurance

Legal aid schemes flourished in many western societies in the post-war era. But as its cost had continuously increased over time and governments in the 1990s began to lose faith in large public policy programs, many governments steadily reduced the expenditure on legal aid[131]. This way legal expenses insurance came into the picture, both as a complementor to and a partial substitute for legal aid[132]. Legal expenses insurance is a contract in which a private insurer agrees, for a premium, to cover in certain categories of cases a policyholder's legal costs. In Belgium, however, the last couple of years the scope and budgetary funds of the legal aid system have only been further expanded, and until very recently no great pains were taken over the promotion of legal expenses insurance[133]. As a result, in comparison with neighbouring countries, in particular Germany[134], the Belgian market for stand-alone[135] legal expenses insurance is fairly underdeveloped at the moment. This might, however, change in the future as the July 2, 2006 meeting of the Cabinet has finally announced a package of measures to promote legal expenses insurance[136].

In this chapter we examine the essential changes in the access to civil justice we can expect, if the measures proposed by the Belgian government turn out successful. The fundamental difficulty that arises once a legal expenses insurer is introduced in our model, is that the three essential roles at one side of a legal dispute are filled by three different actors: the one suing, or getting sued (the plaintiff or defendant), is different from the one spending (his lawyer), is

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[128] See *supra* text accompanying note 123.

[129] See *supra* note 77.

[130] See *supra* section III.3.1 *in fine*.

[131] Kilian and Regan (2004) at 233.

[132] In the US, there is no developed system of legal expenses insurance. This is probably the result of contingency lawyers providing insurance coverage for attorney costs. Legal service plans enjoy some popularity in the US, but they follow different principles to legal expenses insurance, see Killian (2003) at 36-37.

[133] Since the beginning of the current period of office, legal aid expenditure has almost doubled from €25.6 million in 2003 up to more than €43 million in 2005, see Ministerraad (2006).

[134] On legal expenses insurance in Germany, see Kilian (2003).

[135] Many people already have legal expenses insurance as an add-on to more traditional insurance policies but these products only provide limited coverage and most people are even not aware of the fact that they have coverage for legal expenses in those limited cases; therefore its real prospects for improving the access to civil justice lie in stand-alone legal expenses insurance, i.e. policies that are not sold in conjunction with or on top of any other insurance product.

[136] Ministerraad (2006) at 2-3.

different from the one funding (insurer). Each of these players has his own financial interest in the case and possesses certain private information. In the triangular client-lawyer-insurer nexus of contracts each relationship thus qualifies for a principle-agent relationship. Therefore, notwithstanding the fact that the analytical framework is more complex, the analytical tools that are used here are essentially the same as the ones we've used to study the client-lawyer relationship.

Legal expenses insurance policies come in many forms[137]. But rather than on these different forms, the analysis focuses on mandatory regulation and how this may affect the potential for legal expenses insurance to develop as an alternative means for funding the access to civil justice. Typically legal expenses insurance only covers part of a client's legal costs as policies usually incorporate limits and deductibles in addition to exclusions. However, for sake of the argument, the analysis takes as a starting point a policy that provides literally full coverage. Any misunderstanding this could give rise to is corrected for in section IV.2 on attorney costs.

IV.1.   Level of Suit, Settlement and Adjudication – Claim Selection

IV.1.1. Level of Suit

IV.1.1.1. Positive Effects

There is little doubt that legal expenses insurance has positive effects on the level of suit. As a plaintiff holding insurance doesn't bear any litigation costs, he won't take these costs into account when assessing a claim's expected value. Legal expenses insurance thus increases a claim's expected value and the likelihood of suit[138]. Therefore, it may be perfectly rational for a risk-neutral agent to purchase legal expenses insurance, as it strengthens the credibility of his threat to take a dispute he's involved in to trial[139]. In addition, similar to contingency fee arrangements[140], a plaintiff with legal expenses insurance doesn't bear any litigation cost risk. This way legal expenses insurance promotes the filing of suit by risk-averse plaintiffs. Also, it allows liquidity constrained plaintiffs to bring suit where they otherwise wouldn't have been able do so[141]. It should be noted that the premium paid for legal expenses insurance is of no account to a policyholder's rational decision to bring suit since it constitutes a sunk cost, i.e. a cost that has already been incurred and which cannot be recovered to any significant degree[142].

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[137] For a comprehensive overview, see Kilian (2003) at 32-35.
[138] Kirstein (2000), Van Velthoven and Van Wijck (2001).
[139] As firms may be rather risk-neutral than risk-averse, the use of insurance as a strategic device can (partially) explain why also firms buy legal expenses insurance, see Kirstein (2000) at 251.
[140] See *supra* text accompanying note 74.
[141] Van Velthoven and Van Wijck (2001). See also *supra* text accompanying note 73.
[142] However, it has been observed that people don't always behave rational with respect to sunk costs, see Kahneman and Tversky (1979), Arkes and Blumer (1983).

IV.1.1.2. Adverse Selection and Moral Hazard

In addition, the two primary agency problems in the insurer-client relationship tend to increase the level of suit further. Both effects, however, are rather a vice than a virtue since, unless the underlying information asymmetries can be properly addressed, they may cause the legal expenses insurance market to fail[143].

Adverse selection[144] can occur when potential policyholders have different characteristics and/or preferences which make them more (less) likely than others to get involved in litigious situations. When an insurer cannot properly distinguish the different risk types and charges a premium based on the average risk, this will attract high-risk and deter low-risk types from purchasing insurance. Due to this selection effect the odds that a policyholder will get involved in a litigious situation and invokes his policy will be above average. Therefore, the insurer is likely to experience excessive losses as the premium was set according to average risk. In response, the insurer may increase the insurance premium, but this only compounds the problem and leads to an even more adversely selected group of insurance purchasers.

Moral hazard[145] refers here to tendency of insurance protection to alter a policyholder's incentives to prevent the insured event from occurring[146]. A plaintiff holding legal expenses insurance may, for example, rationally have a weaker incentive to spend time and/or money screening future contracting parties for their reputation of being a defaulter, in the knowledge that he won't bear any costs if legal actions have to be taken to secure payment[147]. Moral hazard poses, however, only a real problem if the insurer cannot observe policyholders' behavioral changes so that it cannot be accounted for in advance by a requisite premium charge[148]. In that case the insurer is likely to experience excessive losses as this leaves him exposed to higher levels of risk than was anticipated when the premium was set.

Experience from the Netherlands and Germany suggests that insurers succeed quite well in overcoming these problems. While in the period 2000-04 the number of legal expenses insurance policies increased rapidly in the Netherlands, the relative claim frequency (number of claims per 100 policies) remained practically constant[149]. In Germany, the total increase in the number of litigants as a result of being insured was shown to be only between 5 to 10 pct[150]. Safeguards against adverse selection range from risk-based diversification of premiums to ceilings on the amount of coverage (per insurance period[151]), a variety of available

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[143] Bowles and Rickman (1998) at 197.

[144] See, in general, Rothschild and Stiglitz (1976).

[145] See Arrow (1963).

[146] Moral hazard may also increase the magnitude of the size of the pay-out, see *infra* text accompanying note 185.

[147] On the rationality behind moral hazard, see Pauly (1968).

[148] See Schmidt (1961) at 89.

[149] Verbond van Verzekeraars (2005) at 26-27. See also Kerkmeester (2005) at 210.

[150] Prais (1995) at 439 (citing figures from the research funded by the German Department of Justice *Rechtsschulzversicherung und Rechtsverfolgung* ('Legal Expenses Insurance and the Recourse to the Court')).

[151] This may enhance the determent of high-risk types relative to low-risk types better than a ceiling per claim when/as the former are more likely to file several insurance claims per insurance period.

insurance policies combining different coverage and premium levels[152] and the exclusion of certain risks from insurance[153]. To fend off moral hazard insurers tend not to offer full insurance, but to pass some risk back to consumers (*co-insurance*). The preferable form of co-insurance to counter the type of moral hazard at hand is a *deductible*, which is included in most legal expenses insurance policies[154]. This requires a client to pay in full the first proportion of his legal costs before collecting the rest from his insurer. This not only encourages him to avoid litigious situations, but also cuts the insurer's administrative costs, since – as apposed to co-payments[155] – a client has no incentive to invoke his policy when a dispute only entails minor expenditures[156].

IV.1.1.3. Claim Selection

Associated with the abovementioned positive effects is the common belief that legal expenses insurance causes a flood of unmeritorious litigation[157]. Different from contingency fees, one could also suspect legal expenses insurance of promoting small claims[158]. Basically, the line of reasoning that should be adopted to this issue is the same as the one we've developed on claim selection under contingency fee arrangements. From the point of view of a plaintiff with legal expenses insurance, the smallest chance of recovering a nutshell is a sufficient ground to bring suit. But then again, it's very unlikely that a private insurer will offer coverage for any such claims.

Beforehand, it should be noted that we already know that most legal expenses insurance policies include a deductible. This serves as a selection mechanism since a client will rationally only invoke his policy if the expected judgment exceeds the amount of the deductible[159]. However, this does not entirely preclude the possibility that unmeritorious suits are promoted and only provides a rather remote explanation.

A more fundamental argument – separate from the problem of moral hazard – can be found in one of the essential requirements for a risk to be insurable, namely that an insurer must have a sufficient volume of business. In insurance terms this means that he must be able to group a sufficiently large number of policyholders in a risk-pool. This allows him to diversify risk and become a more efficient risk bearer – which is essential for insurance to be feasible[160]. At first sight, offering coverage for legal expenses irrespective of a claim's potential award and merit seems a quite effective strategy to create a sizeable risk-pool. However, as we've argued above, this intemperate strategy will induce each policyholder to

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[152] This way policyholders may be induced to reveal their type, see Emons (1989) at 50-52 (applying this concept to warranty contracts).
[153] See Kilian (2003) at 39.
[154] For Germany, *id.* at 45.
[155] See *infra* text accompanying note 185.
[156] Economist (1995).
[157] This appears a common concern among German lawyers, judges and 'men on the street', see Prais (1995) at 438; Kilian (2003) at 45.
[158] *Id.*
[159] Kilian (2003) at 45.
[160] See Bowles and Rickman (1998) at 197.

rationally seize with both hands every slightest opportunity to bring suit whatever the chance of success and/or potential award. If then the insurer raises premiums to off-set the flood of insurance claims and the massive administrative costs this would entail, he will encounter another limitation to the insurability of a risk: only when the insurance premium is lower than potential clients' risk-premium the latter will be willing to purchase insurance[161]. Consequently, after premiums have been adjusted to the excessive loss the risk-pool suffers under these conditions, in spite of its broad coverage, most won't be willing to pay anymore for the insurance policy. As a result, insofar as some are still willing to purchase coverage, instead of very large, the risk-pool will be small and – insofar as it doesn't collapse – highly unattractive from the insurer's point of view. This shows that inherent to building up a sizeable risk-pool is a trade-off between keeping premiums at a reasonable level so as to offer a sensible priced product attractive to the masses and ensuring that premium income is sufficient to cover costs. It follows that, in general, this trade-off can most sensibly be solved by reducing coverage to avoid an excessive flood of claims, but to do so without fundamentally affecting the attractiveness of the policy. That is, excluding those claims from coverage for which the willingness to pay is lowest, i.e. claims with a low expected value due to their low potential award and/or low chance of recovery.

That this alternative approach is the more feasible one, appears also in practice. In addition to a deductible, standard legal expenses insurance policies also include additional safeguards to counter unmeritorious litigation, such as a merits test[162]. Also the contractually implied obligation of good faith (Article 1134 of the Belgian Civil Code) allows an insurer to decline coverage for groundless or unreasonable claims, or because of its futility or lack of evidence[163].

The little empirical evidence that is available on legal expenses insurance shows that insofar as there is a difference between claims brought by self-financing and insured plaintiffs, it's that the latter are more inclined to bring small cases. But, all in all, the difference is small[164]. It was also found that 3 pct more of the insured litigants won their case[165]. On the one hand, this could be explained by the better control insurers might have of lawyer opportunism[166]. On the other, insofar also plaintiffs were among the more successful litigants, it may be the reflection of a more careful case screening by insurance companies throughout the dispute resolution process on the basis of 'objective' legal quality[167].

Relative to hourly lawyers[168], legal expenses insurers appear to have indeed a stronger incentive to screen cases more carefully before they declare coverage. Such as a contingency

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[161] On risk-premium, see *supra* note 34.

[162] On Germany, Kilian (2003) at 46.

[163] Colle (2005) at 305.

[164] Prais (1995) at 439.

[165] *Id.*

[166] See *infra* section IV.2.

[167] See *supra* note 44.

[168] As these figures are from a German research report, the self-financing plaintiffs' claims were screened by lawyers paid a fixed fee according to the German BRAGO system. Yet, this doesn't fundamentally change the observation: these lawyers have the rational incentive to accept and continue low-quality claims when they have

lawyer, an insurer's incentives are driven by a direct financial interest in the case, but rather in its legal costs than in its outcome[169]. It's a market-driven incentive, in the sense that an insurer cannot limit coverage too much as this will make his insurance product less attractive compared to competing products in the market and narrow down his risk-pool. On the other hand, if an insurer wants to keep premiums at a competitive level and at least break even, as we've demonstrated above, coverage has to be limited to some extent and cases need to be screened accordingly. Therefore legal expenses insurers employ legally trained personnel to screen, handle and monitor legal disputes in which policyholders are involved. Thus, also an insurer has the required skill and knowledge to screen claims effectively.

IV.1.2. Level of Adjudication

IV.1.2.1. Drop Rate

One may expect that the intensity with which an insured plaintiff will wish to continue a filed claim will be greater than the intensity a self-financing plaintiff will choose[170]. Yet, as it still may turn out after suit was brought and coverage was declared, that a claim lacks quality to such an extent that it's legitimately no longer eligible for insurance coverage, also the insurer can decide to drop a claim covered by legal expenses insurance[171]. Moreover, as in principle an insurer does not have to allow the intervention of a lawyer before the case is brought to court[172], he can handle the claim in-house, which allows him to keep better track of every evolution that might be relevant to his decision whether to withdraw coverage. On the other hand, one should take into account that claims of uninsured plaintiff's will be handled by hourly lawyers, which are unlikely to give them unbiased advice on the claim's quality both at the filing and drop stage. Therefore, similar to the effect of fee arrangements on the drop rate[173], two counteracting effects determine the effect of legal expenses insurance on the drop rate.

First, given the stronger incentive of insurers to screen cases for their true quality, they may detect more claims that no longer fit the conditions for insurance coverage, relative to the number of claims an hourly lawyer advises his uninsured client to no longer pursue (*screening effect*).

Second, as hourly lawyers do also not perform their screening function as carefully as legal expenses insurers at the filing stage, claims of self-financing plaintiffs reaching the drop stage

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uncommitted time too, since the fixed fee is payable anew in every stage of the litigation process, see Leipold (1995) at 271-74.

[169] However, if the English cost-allocation rule applies, the legal costs an insurer may have to reimburse depend directly on the outcome of the case; there is little doubt that then case screening will be performed even more thoroughly. See Rickman and Gray (1998) at 311.

[170] Bowles and Rickman (1998) at 197.

[171] After the insurer has withdrawn coverage, a plaintiff may either drop his claim entirely or continue his claim as a self-financing plaintiff.

[172] Article 4.1 (a) Directive 87/344/EC on the Coordination of Laws, Regulations and Administrative Provisions relating to Legal Expenses Insurance, official reporter EC Nr. L 185, 4 July 1987, 77.

[173] See *supra* text accompanying notes 87-89.

will be of average lower quality. Therefore, it might be that more claims are dropped on the initiative of self-financing plaintiffs after they've discovered the true quality of their claim, than on the initiative of insured plaintiffs (*selection effect*).

No empirical data is available to make any statement on which of both effects might dominate the other.

IV.1.2.2. Settlement Rate

Parties' incentives to settle stem essentially from the costs of trial, which they can avoid by resolving their dispute among one another. This is reflected in the settlement surplus, which increases as the expected costs of litigation rise. But as legal expenses insurance reimburses an insured party's litigation costs, it has the obvious effect of decreasing the settlement surplus along with the likelihood of settlement[174]. Further, by eliminating the litigation cost risk, legal expenses insurance weakens the settlement promoting effect of an insured party's risk aversion. Settlement will be discouraged most if both parties to the dispute hold legal expenses insurance, as both their minimum acceptable settlement amount will abstract from the costs and uncertainty of trial.

These conclusions, however, are incomplete in a fundamental aspect as the active role legal expenses insurers may play in settlement negotiations is not taken into account. In some jurisdictions, such as Germany, monopoly rights for lawyers limit an insurance company's involvement in a case to declaring coverage and reimbursing legal expenses[175]. In Belgium, however, an insurer can reserve himself the right to take all necessary steps to get the case settled[176]. As an insurer can save costs if the case doesn't go to court, he's very likely to use this possibility to foster settlement. To that end, he might be induced to be more lenient towards the opposing party and thus increase the settlement probability. On the other hand, to some extent, this incentive is counteracted by the fact that such a leniency could negatively affect the attractiveness of the insurance policy, the insurer's reputation and in turn his profits[177]. But given the client's relative ignorance, it's very unlikely that this will entirely keep the insurer's incentive to endeavour settlement from partially offsetting the weaker incentive clients have to settle their dispute[178].

Empirical data confirms that legal expenses insurance discourages settlement. In Germany between 5 to 8 pct more litigants proceeded to trial if they were insured than if they were not insured[179]. In Belgium, however, the fact that 80 pct of all claims covered by legal expenses insurance are settled, is generally perceived as a clear indication that insurance companies

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[174] Kirstein (2000), Van Velthoven and Van Wijck (2001).

[175] For Germany, see Kilian (2003) at 37.

[176] Colle (2005) at 304.

[177] Van Velthoven and Van Wijck (2001) at 394n14.

[178] Heyes et al. (2004) show that also asymmetry of information between the parties may positively affect the settlement rate.

[179] Prais (1995) at 439. However, this data should be handled with care as it's unclear whether it's corrected for any selection effect that might have occurred at the drop stage.

contribute to private dispute resolution[180]. Unfortunately, more reliable data is not available – let alone empirical data that would allow to determine to what extent the different role insurers play in settlement negotiations affects settlement rates in Germany relative to Belgium.

IV.1.2.3. Eventual Level of Adjudication

On the basis of the forgoing analysis no concrete theoretical proposition can be advanced on the ultimate effect of legal expenses insurance on the level of adjudication. What is, however, clear is that insofar as the insurer is allowed to handle claims himself and to take an active role in the settlement process, this is likely to keep more claims out of court. Lack of empirical data that combines information on both the parties' drop and settlement behavior prevents us from drawing any final conclusion on the ultimate level of adjudication.

IV.2. Litigation Costs

The effect of legal expenses insurance on litigation costs is relevant to our discussion because of two reasons. First, in order to keep insurance premiums at a for consumers attractive level, it is of paramount importance that an insurer is able to calculate the risk carried by a policy underwritten, and can keep control of and reduce costs[181]. Second, as we've already mentioned before, insurance policies typically do not provide full coverage. Consequentially, the magnitude of (that part of) the litigation costs born by the insured will determine the ultimate extent to which the positive effects of legal expenses insurance on the level of suit will effectively contribute to the accessibility of justice. Also, its effects on the insured's attitude to dropping and settling a filed claim are mitigated to the extent that he still expects to bear litigation costs.

In the previous chapter, we've discussed how in the current hourly fee system lawyer opportunism may affect attorney costs. The source of this moral hazard problem is the conflict between the client's and lawyer's financial interest in the case: while an hourly lawyer benefits from billable hours, his client is only interested in a maximum net return to the case and therefore he wants his lawyer to spend only the optimal amount of time on the case. When the client has legal expenses insurance, however, the factor that drives a wedge between his and his lawyer's interest is eliminated. Rather than conflict, their interests tend to converge, as the insured client doesn't bear any legal costs and can't thus anything but benefit from additional investments in the case. Therefore, if legal expenses insurance covers the entire litigation cost, the client will have every incentive to encourage his lawyer to further increase inputs on the case[182], while the latter will feel less restricted to behave opportunistically given the deep pockets of the insurance company. As a result, the latter

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[180] Colle (2005) at 304.
[181] Kilian (2003) at 42-43.
[182] Bowles and Rickman (1998) at 200.

faces a moral hazard problem in his relationship with both the insured and his lawyer. In both relationships, however, certain measures can be taken to minimize this problem.

IV.2.1. Insurer-Client Relationship

As was mentioned above, co-insurance is the most appropriate instrument to address moral hazard in the insurer-client relationship. In most legal expenses insurance policies this is already incorporated by means of a deductible, frequently combined with a ceiling on the amount of coverage[183]. Yet, this doesn't provide the insured with appropriate incentives to keep control of costs above and below the respective limits to his policy[184]. Actually, the form of moral hazard at hand is most effectively countered by *co-payment*: this requires the insured to pay a fraction of the entire cost[185]. This solution, however, suffers from some limitations. First, co-insurance allows to keep premiums down, but at the downside it also limits insurance coverage and thereby the attractiveness of the insurance, in particular when both a deductible and co-payment are combined. Second, relative ignorance and limited monitoring possibilities typically prevent clients from entirely keeping control of lawyer opportunism even when a claim is privately funded. They for sure won't do a better job if they only bear (internalize) part of the litigation costs (benefits).

IV.2.2. Insurer-Lawyer Relationship

Given the limitations of co-insurance, insurers also try to achieve a more effective control and reduction of costs directly in their relationship with legal service providers. Basically, three different options may be open to legal expenses insurers in this respect. But more than in the insurer-client relationship, the feasibility of these options is dependent on, and restricted by mandatory regulation.

IV.2.2.1. Formal Fee Regulation

Often cited in relation to the success of legal expenses insurance in Germany is the option to improve the predictability of attorney costs through formal regulation of attorney fees[186]. When based on fixed fees, such as the German BRAGO system, this also allows for better cost control[187]. In Belgium, however, insurers cannot rely on any formal fee regulation, neither binding nor indicative, after the withdrawal of the recommendation of the former National Bar Association in this respect[188]. Recently, some have mentioned attorney fee

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[183] See *supra* text accompanying notes 151 and 154.
[184] Deductibles can even increase the moral hazard that raises the size of potential losses, see Economist (1995).
[185] *Id.*
[186] Kilian (2003) at 42.
[187] There is no need to control the hours a lawyer effectively spent as the fixed fees are calculated independent from the amount of time spent on the case. Of course, quality control is not solved by this.
[188] Lamon (2002) at 4.

regulation as a means to curb the increased expenditures effect cost shifting entails but this suggestion seems to carry anything but general support[189].

IV.2.2.2. In-House Services

No doubt, cost control and reduction, in addition to quality control, can be most effectively achieved through the provision of legal services by in-house salaried personal[190]. This option holds certain potential for Belgian insurers as lawyers' monopoly rights only extent to representation in court. As mentioned before, insurers make frequent use of this option to foster settlement[191]. However, its prospects are limited because policyholders have always the right to free choice of counsel from the moment they are involved in judicial or administrative proceedings[192]. Further, an insurer can only provide in-house services through jurists, as the independence of the legal profession does not allow lawyers to work in salaried employment[193].

IV.2.2.3. Direct Control and Self-Enforcing Mechanisms

Finally, absent formal attorney fee regulation and given the limited possibility to provide in-house services, insurers will necessarily have to rely on direct control and self-enforcing mechanisms[194]. To that end, an insurer will preferably invest effort in building up an open-ended relationship with a selected number of lawyers and law firms, which handle legal expenses insurance cases on a routine basis with the prospect of future business born in mind.

This is also observed in practice. It is, for example, very common for a legal expenses insurer and a lawyer to set up their own long term informal fee structure[195]. Also, the Flemish Bar Association and the professional association of insurers have agreed on a body of soft law governing the legal expenses insurer-lawyer relationship[196]. This does not only provide a general framework within which an insured's dispute is handled, but also allows for better control of lawyer performance and costs, both directly (time records, work sheets, etc.) and indirectly (exchange of information, mutual consultation, etc.). Even so, an insurer will still face certain practical, economical and/or legal barriers, which prevent him from exercising full control over lawyer performance. In particular, quality control may be very hard to accomplish pending the case's outcome.

Here, however, the prospect of future business steps in to cover for this lack of direct control. More than likely, a full evaluation of lawyer performance by the insurer's legal

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[189] See, e.g., Orde van Vlaamse Balies (2006), Van Parys (2006).
[190] Kilian (2003) at 43.
[191] See *supra* text accompanying notes 178 and 180.
[192] Article 4.1 (a) Directive 87/344/EC on the Coordination of Laws, Regulations and Administrative Provisions relating to Legal Expenses Insurance, official reporter EC Nr. L 185, 4 July 1987, 77.
[193] See the regulation of the attorney statute in Orde van Vlaamse Balies (2005).
[194] See on self-enforcement, in general, Klein (1980), Klein and Leffler (1981).
[195] Hubeau (2006) at 65.
[196] Vereniging van Vlaamse Balies and BVVO (1999).

personnel is feasible after the case is closed, as opposed to before[197]. This enables the latter to sanction lawyer opportunism *ex post* through withdrawal of future business. In anticipation of this, a lawyer will rationally abstain from shirking as long as he expects the future income from the insurer-lawyer relationship to exceed the profit he can earn by economizing on quality in a case at hand. In this respect, a more moderated control of lawyer performance may suffice to ensure a probability of detection (and thus loss of future income) sufficiently high to keep this self-enforcing mechanism running. As a result, the combination of both high-qualified legal personnel and the position of large costumer in the market for legal services may allow a legal expenses insurer to control lawyer opportunism to quite a reasonable extent. Moreover, given the oversupply which characterizes the Belgian market for legal services, this self-enforcing mechanism may even extent to lawyers which were appointed by an individual policyholder on the basis of his right to free choice of counsel.

IV.3. Duration of Claims

IV.3.1. Dropped Claims

Crucial to our discussion on the effect of legal expenses insurance on the drop rate was the strong incentive of an insurer to keep track of claim quality, opposed to the skewed incentives hourly lawyers may have in this respect[198]. As a result, a self-financing plaintiff is rather left to his own advice when deciding whether or not the drop his claim, while a plaintiff holding legal expenses insurance is in fact more likely to be confronted with his insurer's decision to drop a claim than to drop the claim himself. This fundamental difference is very likely to be reflected in claims that are privately funded to take longer to be dropped than claims covered by legal expenses insurance. Simply because an insurer is much more competent than a self-financing plaintiff to collect, process and evaluate the relevant information on the basis of which the decision to drop a claim is taken.

IV.3.2. Settled Claims

As an insurer can save costs if the case doesn't go to court, legal expenses insurers typically reserve themselves the right to foster settlement[199]. Therefore, if the insured's claim actually gets settled, it should normally take shorter than if the case were privately funded and thus settled by an hourly lawyer. The reason is that an insurer internalizes the full opportunity cost of his time, as opposed to an hourly lawyer who gets actually paid for spending more time on a case and is thus likely to shirk as his performance is typically only partially verifiable by his client. An insurer's personnel may shirk as well, but no doubt the employer-employee relationship leaves much more room for control, incentive payments, etc. than the relationship

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[197] As legal expenses insurers employ legally trained personnel and hire lawyers on a daily basis, legal services are very likely to be experience rather than credence goods to them. See also *supra* text accompanying note 100.
[198] See *supra* text accompanying notes 170-172.
[199] See *supra* text accompanying note 176.

between a lawyer and his client. Most importantly, however, even when not the insurer settles the case, but a lawyer that was appointed by him (or even by the insured), one might expect it to take shorter given the prospects, we've just discussed, the insurer-lawyer relationship holds for keeping control of lawyer opportunism.

This has been empirically confirmed by Fenn et al. (2006:24-25), who report that in England and Wales settled claims covered by legal expenses insurance have shorter durations by comparison with all other forms of case funding.

IV.3.3. Adjudicated Claims

Finally, the insurer's control over the duration of claims will be most restricted when claims are disposed of through adjudication. That is because from the moment a case goes to court the insurer has to guarantee his client the right to free choice of counsel[200]. Insofar as the latter prefers his own choice to the insurer's, the latter mainly will have to rely on direct control to keep the lawyer from shirking and spending too much time on pre-trial and trial proceedings. But just as when the case is settled by a lawyer and not by the insurer himself, one still may expect the insurer's legally trained personnel to do a much more effective job than a typical self-financing plaintiff. In addition, given the oversupply which characterzes the Belgian market for legal services today, again, one could argue that merely the hope for future business might (partially) trigger the self-enforcing mechanism and lead lawyers, even when appointed by the insured, to behave less opportunistally.

Conclusion

To conclude, let us first reconsider the policy issue addressed in this paper. At present time, apart from legal aid, private funding is the dominant method of funding a civil claim in Belgium. The economic analysis presented in this paper has indirectly pointed at four failures of the current funding scheme which all add to the relative inaccessibility of civil justice today. First, as far as the letter of the law concerns, the basic principle of indemnity of litigation costs does not apply to attorney and expert costs. As a result, there is a considerable risk that a perfectly valid claim turns out to be a negative expected value suit. If the amount at stake is relatively low, this may even be the case when there is a 100 pct chance of prevailing at trial. Second, typically legal expenses, including attorney costs, have to be paid before any award has been collected to cover costs. Thus liquidity constrained plaintiffs who cannot afford the upfront payment of legal costs, are prevented from asserting their subjective rights, even when their claim has a positive expected value. Third, as in the private funding scheme the entire cost and proceed risk is allocated to the client, it paves the way for the plaintiff's likely risk aversion to further obstruct the access to civil justice. Finally, the current funding scheme doesn't offer any direct possibility to address the typical client-lawyer agency

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[200] Article 4.1 (a) Directive 87/344/EC on the Coordination of Laws, Regulations and Administrative Provisions relating to Legal Expenses Insurance, official reporter EC Nr. L 185, 4 July 1987, 77.

problems, which cause both litigation costs to rise and the client's interest to be neglected. This is reflected in all different stages of the dispute resolution model, leading clients to be wrongly advised on the quality of their claim, lawyers taking too long to settle and putting too little effort, and so forth.

The prospects for improving the access to civil justice of the alternative funding options subject to this study, can be evaluated most effectively by considering the extent to which they allow to overcome the failures inherent to the current funding scheme. From a theoretical point of view, at first sight, cost shifting appears the most appropriate method for solving the first of the aforementioned failures. By shifting litigation costs to the losing party at trial, one would indeed expect the English rule to clear the path at least for highly meritorious claims, even when they have a relatively low potential award. However, the empirical evidence presented by Snyder and Hughes (1990:364) suggests that, when a cost-shifting rule applies, parties' greater expenditures, the increased litigation risk and the defendant's outspending weigh that much on the claim's expected value that the English rule has an overall negative effect. Apparentely, aggrevating rather than solving the other failures of the private funding scheme, cost shifting leads plaintiffs only to continue a selected subset of claims that combine a high probability of success with a relatively large potential award. It should, however, be noted that the validity of this empirical observation is subject to certain limitations. First, the empirical evidence we've discussed is only concerned with a full-blown cost-shifting rule that holds the losing party liable for all reasonable costs. Also, the theoretical analysis is essentially inconclusive on the ultimate effect the English rule has on the volume of suit and drop rate. Therefore, it's perfectly possible that under a more moderated indemnity rule that only shifts costs up to a certain limit, the English rule's positive effects on a claim's expected value are not outweighed by the the greater expenditures effect, the increased litigation risk and the defendant's outspending. Further, one could argue that the increased expenditures effect as observed by Snyder and Hughes (1990:374) can, to a large extent, be attributed to the typical characterstics of US medical malpractice litigation, which is much more accusatorial than the Belgian civil justice administration system.

As opposed to the English rule, which doesn't incorporate any risk sharing benefits and only increases the risk and costs of litigation, contingency fees hold clear prospects for overcoming risk aversion and liquidity constraints. However, it follows from the economic dispute resolution model that a claim will only be brought on a contingency fee basis when not only the client's but also the lawyer's expected value is positive. Therefore, contrary to what is commonly believed, this improved accesibility of justice does not neccessarily imply a deterioration of claim quality. The effects of fee arrangements on lawyer opportunism are more ambiguous. In a contingency fee as well as in an hourly fee setting, lawyers may capitalize on clients' relative ignorance and the limited verifiability of their performance. But while mainly fee negotations were found to be suspectible to contingency lawyer opportunism, the entire dispute resolution model appears to be fraud with potential grounds for opportunistic behavior by hourly lawyers, especially when they have uncommitted time.

This is most illustratively reflected in the fact that actually hourly fees rather than contingency fees promote frivolous litigation. Not surprisingly, Brickman (2003a:106) suggests that the overall agency costs in hourly fee arrangements are excessive compared to the costs of contingency lawyer opportunism.

Finally, to the extent costs are covered by an insurance policy, legal expenses insurance has a positive effect on a claim's expected value. Also, legal expenses insurance improves the access to civil justice of plaintiffs that are risk-averse and/or liquidity constraint. Moral harzard, adverse selection and market-driven incentives were shown to induce insurers, either directly or indirectly, not to offer coverage for claims that lack merit or have a relatively low potential award. Furthermore, within the current legal framework, there does not appear to be any fundamental obstacle to the development of a market for legal expenses insurance. However, absent a formal fee regulation, insurance companies can only keep control of cost through direct control and self-enforcing mechanisms as well as the provision of in-house services. If this allows legal expenses insurance to successfully expand its range, this may not only lower prices, but also benefit consumers as enhanced control may lead lawyers to behave less opportunistically. But, on the other hand, it remains unclear whether lawyers will actually redirect their behavior in the interest of the client. It doesn't seem unrealistic at all that as the market for legal expenses insurance grows and insurers increase their hold of the demand for legal services, lawyers rather will redirect their behavior in the insurers' interest. This in turn points at potential grounds for opportunistic behavior by the insurer, which however were generally left undiscussed here. This leaves an open and interesting field for further research on the extent to which clients' relative ignorance, limited monitoring abilities and market incentives, in combination with insurers' increasingly dominant position in the market for legal services may allow them to behave opportunistally towards their clients. It may well be that the expansion of the market for legal expenses insurance will ignite a call for regulation to safeguard lawyers' independency in order to achieve the right balance in the client-lawyer-insurer nexus of contracts. The potential problem of insurer opportunism may be even much more imminent insofar as insurance companies may provide in-house services. As their direct involvement in the civil justice administration system increases, one could openly question whether legal expenses insurers shouldn't be subject to similar provision as those currently governing the client-lawyer relationship. But for now, it's clear that any regulatory intervention in this respect will have to deal with a subtle trade-off between protecting the interest of individual clients, and the promotion and expansion of the market for legal expenses insurance *in globo* which requires insurers' direct or indirect control.

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