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FORIS contracts: Litigation Cost Shifting and Contingent Fees in Germany

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FORIS contracts: Litigation Cost Shifting and Contingent Fees in Germany[†]

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Abstract

This paper analyzes the impact of FORIS contracts on litigation and settlement decisions using a simple divergent-expectations model. A FORIS contract introduces contingent fee arrangements under the British legal cost allocation rule: the plaintiff pays a percentage of his settlement or trial returns to FORIS and obtains coverage for trial costs in case he loses in court; the plaintiff's attorney receives the standard fee.

We take into account the sequential nature of the settlement and trial decisions. Without FORIS contracts, only cases with positive expected value provide credible threats for the plaintiff and thereby motivate the defendant to agree to a settlement. A FORIS contract has two important effects: cases with negative expected value are turned into credible threats, hence a settlement is triggered. Even in positive expected value cases, the settlement result for the plaintiff is increased.

According to our results, FORIS should prohibit settlement negotiations before a contract with the plaintiff has been made. The paper argues that FORIS should abolish the non-disclosure clause which prohibits the plaintiff to reveal the existence of the FORIS contract to a third party.

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Contents

1 Introduction

One of the most important problems of civil litigation is the cost barrier plaintiffs face. This barrier may keep plaintiffs from pursuing their case, even if their claim is legitimate. The problem is obvious under the American cost allocation rule, where each litigant has to bear its own costs, regardless of who prevails in court. If the plaintiff's costs are too high, the option to sue has a negative expected value. In this case, the threat to sue is not credible and thus is worthless.[1] The legal system is unable to protect the rights of such a plaintiff.

Even under the British or European cost allocation rule - which in general requires the losing litigant to pay both parties' costs - a case can easily have a negative expected value. Consider an amount at stake of 50.000 Euros. The cost risk a plaintiff faces amounts to about 40.000 Euros.[2] The expected value of the trial is computed as the amount at stake times the probability to prevail, net of the costs times the probability to loose. If the plaintiff in this example estimates his probability to prevail to be less than 0.44, then the case has negative expected value for him. The costs are even higher if the plaintiff expects the final decision to be made only in appeal.

Three different kinds of attempts to solve the cost barrier problem can be observed, namely

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[1] Note that this is true even if the option to sue is only considered as a threat in settlement negotiations, see BEBCHUK (1988), (1996), (1998).

[2] See ROLLMANN (1999, 203). The costs are regressive, however: For an amount at stake of 500.000 Euros, the author calculates a cost risk of 125.000 Euros. Rollmann, one of the founders of the FORIS AG, estimates that about 17.000 lawsuits per year in Germany are not brought due to this cost risk, though he does not add any remark as to the merits of these cases.

- Contingent fees: The prevailing plaintiff pays his attorney a portion of the proceeds, whereas he pays nothing if he loses the case.[3]

- Legal Cost Insurance: A potential litigant purchases an insurance against the financial risk of a trial.

- Legal aid: Plaintiff's of lower income receive a (tax-financed) subsidy that covers at least a part of their costs.[4]

Legal Cost Insurance is rare in the United States, yet very common in Europe (in particular in Germany). In some European jurisdictions, such as Germany, it is well established; in others, such as the UK, it is developing fast. One possible reason for its limited availability in the US is that the American rule reduces the risks associated with litigation. Under this rule, risk depends largely on the decisions of the insured plaintiff, which may be reasonably predictable. As a result, the American cost allocation rule may not stimulate demand Legal Cost Insurance.[5] Under the British rule, Legal Cost Insurance makes more sense: the insurer covers a risk (of losing in court) the occurrence of which does not only depend on decisions of the insured, but also of the those of the judge or jury (which cannot be foreseen with certainty). Furthermore, the expected cost at stake may also depend on the defendant's decisions.

Another reason for the position of Legal Cost Insurance in the US is the widespread availability of contingent fees. In contrast, these are less familiar in Europe. This may be due to the difficulties of organizing contingent fee arrangements under the British rule:[6] if, under the British rule, a plaintiff prevails, then he has to pay nothing, whereas a contingent fee arrangement would require him to pay a share of the proceeds to his attorney. In the event of loss, he has to pay both parties' costs under the British rule, but nothing under the contingent fee agreement. This suggests a potential incompatibility between the British rule and the concept of contingent fees.[7]

Despite this apparent incompatibility some new firms in Germany, the first of which was FORIS AG in Berlin, now offer contingent fee arrangements for plaintiffs.[8] FORIS initially demanded one half of the client's returns from trial or settlement - nowadays, with more competition in this market, FORIS only

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[3]PAINTER (1995, 626).

[4]In Germany, legal aid does not cover the opposing attorney's fees, which still creates a considerable cost risk for a low-income plaintiff.

[5]See, however, KIRSTEIN (2000) who analyzes Legal Cost Insurance as a strategic device rather than as a mean to reallocate risks. This focus explains why even under the American rule, and even if both the insurer and the insured are assumed to be risk neutral, an insurance contract can be bilaterally beneficial.

[6]See PAINTNER (1995, 631), but also SMITH (1992).

[7]This incompatibility problem differs substantially from the problem that has received much attention in the literature on contingent fees (under the American rule), namely the incentives of the attorney; see, e.g., EMONS (2000).

[8]Recall that the German legal system is governed by the British cost allocation rule.

claims 30 percent.[9] In turn, FORIS pays both parties' costs if the plaintiff looses in court. FORIS offers to accept cases, only after an evaluation of the odds, at any stage of the procedure, even if suit has already been brought. The plaintiff's attorney still receives his standard fees,[10] thus his incentives are not altered directly by the FORIS contract.[11]

This paper provides a first attempt to analyze this new business idea. We present a simple model with litigation and settlement, drawing on the literature on divergent expectations[12] and on the credibility of the threat to sue.[13] Our model provides first insights into how a FORIS contract (and the opportunity to make such contracts) influences the outcome of settlement and the positions of the litigants involved.

There is a surprising clause in the standard contract FORIS offers to its clients: the plaintiff is prohibited from revealing to a third party the fact that the contract has been made. FORIS gives no reason for this clause, but one of its competitors explains that the existence of such a contract might be due to thefact that the presence of insurance may act as a signal that the plaintiff is not sufficiently convinced of the merits of his case.[14] If the judge interprets the existence of the contract this way, this might damage the plaintiff's prospects in court. The effect of a FORIS contract that is governed by this clause is limited: it only serves as an insurance that shields the plaintiff from the cost risk if the parties do not reach a settlement and the case proceeds to trial.

However, our model questions the benefits of this clause. We model the impact of a FORIS contract without this clause on the settlement and trial decisions of the parties and show that there exists a strategic effect of a FORIS contract: the settlement result for the plaintiff can be increased. This strategic effect generates an additional cooperation rent between FORIS and its client.[15] Making use of the non-revelation clause would destroy this chance to attract additional clients.

[9]Among the now numerous competitors of FORIS AG (see *www.foris-ag.de*) in Germany, Switzerland, and Austria are *www.juragent-derprozessfinanzierer.de*, *www.prozessfinanzierung.at*, *www.das-profi.de*, *www.exactor.de* and *www.gloria-prozessfinanzierung.de*.

[10]These are determined by the Bundesrechtsanwaltsgebührenordnung (BRAGO).

[11]Some related developments have begun to emerge in England and Wales, where *conditional fees*, coupled with Legal Cost Insurance, provide the plaintiff with some protection against costs. The attorney does not receive a percentage of winnings (as an attorney under the contingent fee system, or as FORIS, does) but a mark-up on hourly costs which provides some measure of "output based" incentive. See GRAVELLE/WATERSON (1993) and RICKMAN/FENN/GRAY (1999).

[12]The first contribution to this approach was SHAVELL (1982). See also PRIEST/KLEIN (1985), WITTMAN (1985), KLEIN (1985), EISENBERG (1990), STANLEY/COURSEY (1990), THOMAS (1995), KESSLER/MEITES/MILLER (1996).

[13]See BEBCHUK (1988), BEBCHUK (1996), BEBCHUK (1998) and KIRSTEIN (2000).

[14]See *www.das-profi.de/kuendigung.html*. A rather frivolous reason for the non-revelation clause would be the hypothetical possibility for FORIS to represent both litigants, e.g. if the defendant brings a counter-suit.

[15]According to SCHELLING (1956), a strategic move needs to be communicated in time in order to have a strategic effect.

Furthermore, our model shows that this strategic effect can make a FORIS contract attractive for plaintiffs for the whole range (from zero to one) of subjective probabilities to prevail. Therefore, a rational judge is unable to infer from the existence of a contract the plaintiff's subjective estimation of his case's strength. The reason for this clause clearly warrants further research.

FORIS contracts include other interesting clauses that would merit research, but are ignored in this paper so as to focus on matters raised above. One particular example is the clause that allows FORIS (as well as its competitors) to reserve a veto right if the plaintiff wants to reject a settlement offer by the defendant. If FORIS carries out this veto, then the plaintiff has to put FORIS in the same position as if the settlement had been accepted: FORIS collects its share of the defendant's offer and does not have to cover any trial costs.

We show that FORIS contracts can be bilaterally beneficial when the veto clause is not present; and we expect this clause to trigger more settlements rather than less which would even strengthen our argument. We also omit analysis of the incentives faced by the plaintiff's attorney (though, as noted above, these may not differ too greatly from those under "typical" funding arrangements), as well as the idea that defendant's may also demand FORIS contracts - this kind of contractual arrangement in not known yet, at least not in Germany.[16]

2 Analysis of the FORIS contract

2.1 The model

Three players are involved: a plaintiff (P), a defendant (D), and FORIS (F). All of them are assumed to be risk-neutral. P has a legitimate claim against D, the value of which is denoted as $Y > 0$. Litigation costs of both parties add up to $G > 0$ if a trial occurs, whereas settlement costs are zero. We assume the British cost allocation rule: the loser has to pay both parties' costs.

Both players have subjective probabilities that P wins the trial.[17] We denote the subjective probability of litigant $i \in \{P; D\}$ as q_i, with $0 < q_i < 1$. The parameters q_P and q_D are the subjects of comparative statics in the following sections, whereas Y and G are held fixed throughout.

The interaction takes place in - at most - four steps:

1. P and D negotiate over a settlement. If they agree upon a payment T,

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[16]Painter (1995, 626) mentions the possibility of "reverse" contingent fees; in this case the defendant's attorney would receive a share of the amount his client saves if he prevails in court.

[17]F and P are assumed to have identical beliefs as to the plaintiff's chances of prevailing in court. This assumption does not reflect the expertise FORIS may have in evaluating a case, though it is possiblt that P's attorney may have provided similar advice. However, this simplification helps to keep the model tractable.

the game ends and the payoffs of P, D, and F are $[T, -T, 0]$.

2. P and F bargain over a FORIS contract. If they make a contract then F commits to covering the litigation costs if P loses at trial.[18] In turn, F receives a share $\mu \in]0, 1[$ of all returns P acquires. Without a contract, F receives nothing and P has to bear the full litigation costs in case of loss.

3. After the contract stage, P and D may (again) negotiate over a settlement. If they come to an agreement then the payoffs are $[S, -S, 0]$ without a FORIS contract, and $[(1-\mu)S_F, -S_F, \mu S_F]$ if a FORIS contract has been made. To keep the analysis simple, we assume the symmetric Nash bargaining solution (with equal bargaining power) when solving for the settlement amount.[19]

4. If no settlement has occurred, P decides whether to proceed to trial or not. Without a FORIS contract, the expected payoffs amount to $[q_P Y - (1-q_P)G, -q_D(Y+G), 0]$. If, on the other hand, a FORIS contract exists, the payoffs are $[(1-\mu)q_P Y, -q_D(Y+G), \mu q_P Y - (1-q_P)G]$.

In the following sections, we analyze the subgame perfect equilibria of three different versions of this game. The first game only consists of stages 3 and 4. This is equivalent to a situation where FORIS contracts are not available at all. This game is analyzed in section 2.2.

The second game includes the stages 2, 3, and 4. This models a situation in which FORIS accepts only customers that have not started to bargain over settlements yet, which we analyze in section 2.3.

The third game contains the additional stage 1 and is analyzed in section 2.4. This amendment allows for the analysis of settlement negotiations that take place even before a FORIS contract has been made.

2.2   No FORIS contracts at all

Figure 1 shows the sequence of events in game 1 which is limited to stages 3 and 4 as described above. The first event is the settlement bargaining between P and D, represented by the rectangle in Figure 1 that is labeled with (P, D). If the parties come to an agreement, the payoffs of P, D and F (who is not involved yet) are $[S, -S, 0]$. The other payoffs can easily be derived, using the trial technology: if P proceeds to trial, he expects to prevail with probability q_P, which would yield Y. He expects to lose with probability $(1 - q_P)$, having to bear litigation costs G. D expects to lose with probability q_D; in this case

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[18]This assumption would be loosened by taking into account the veto clause provided by the standard FORIS contract.

[19]Our results would also hold for an asymmetric bargaining situation, as long as the bargaining power is not entirely in the plaintiff's hands. In this case his position cannot be improved anymore by a strategic move.

he has to pay $Y + G$, and zero otherwise. If P does not proceed to court, all players get zero payoff.

Figure 1: Event tree of Game 1
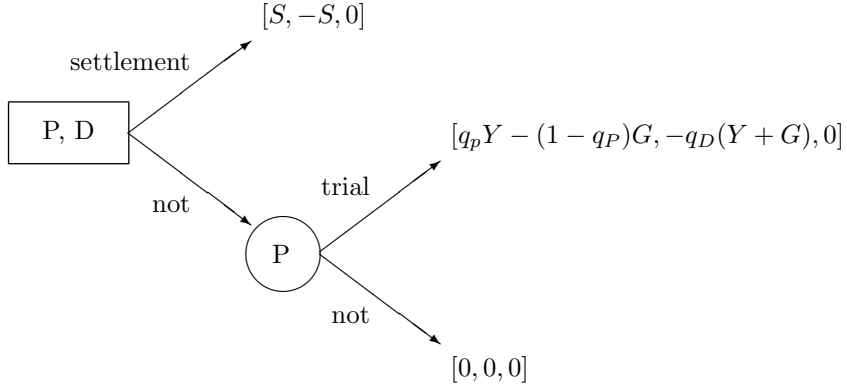
We start the derivation of subgame perfect equilibria with the analysis of the trial stage. If settlement has failed, P will only proceed to trial if the case has positive expected value (PEV), i.e. if $q_P Y - (1 - q_P)G > 0$. This condition is equivalent to

$$q_P > \frac{G}{Y + G} \tag{1}$$

If condition (1) is fulfilled, then D faces an expected loss of $-q_D(Y+G)$ if he fails to settle. A settlement payment S is hence acceptable for him if $S < q_D(Y+G)$. P's expected payoff is $q_P Y - (1 - q_P)G$ if no settlement occurs and the parties meet in court. Thus, P accepts a settlement if $S > q_P Y - (1 - q_P)G$. Therefore, the bargaining range in a PEV case without FORIS contract is

$$]q_P Y - (1 - q_P)G, q_D(Y + G)[\tag{2}$$

If this bargaining range is empty, the parties do not come to an agreement, and P proceeds to court. The condition for this outcome is $q_P Y - (1 - q_P)G > q_D(Y + G)$ or, equivalently,

$$q_P > q_D + \frac{G}{Y + G} \tag{3}$$

If, on the other hand, $q_P Y - (1 - q_P)G < q_D(Y + G)$, then the bargaining range is non-empty and the parties agree upon a settlement. Applying the

symmetric Nash bargaining solution, the predicted bargaining result is $\hat{S} = 0.5[q_P Y - (1 - q_P)G] + 0.5q_D(Y + G)$ or, equivalently,

$$\hat{S} = 0.5[(q_p + q_D)(Y + G) - G] \tag{4}$$

If, on the other hand, $q_P Y - (1 - q_P)G < 0$ then the case has negative expected value (NEV).[20] If settlement fails, then the payoffs of P and D are zero. Thus, the bargaining range is $]0, 0[= \emptyset$. Therefore, P's threat to sue is not credible. D is not motivated to accept a positive settlement result. This leads to our first result:

> **Result 1:** In Game 1, given Y, G, q_P and q_D, the parties P and D
>
> - meet in court if, and only if, $q_P > q_D + G/(Y + G)$,
> - come to a settlement $\hat{S}$ if, and only if, $G/(Y + G) < q_P < q_D + G/(Y + G)$,
> - neither go to court, nor settle if, and only if, $G/(Y + G) > q_P$

Figure 2 presents the three possible outcomes of Game 1, depending on the parameters q_D and q_P. The small diagonal line represents condition (3), the horizontal line represents condition (1). In the upper left triangle, the subgame perfect equilibrium path is (no settlement, trial). In the lower rectangle, the case has NEV and the equilibrium path is (no settlement, no trial). In the upper right area, the parties come to a settlement payment $\hat{S}$ in equilibrium.

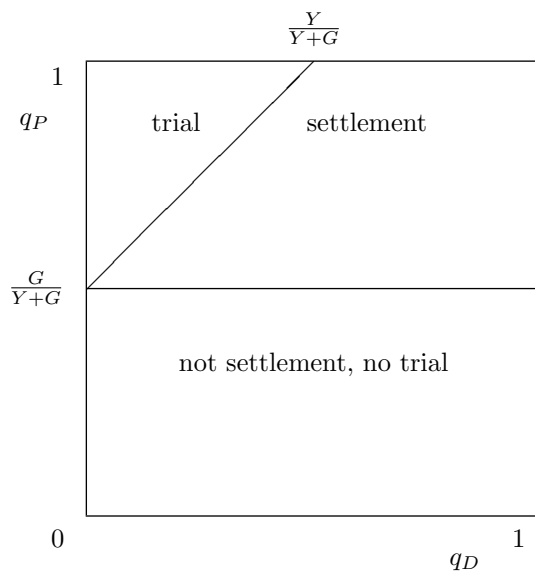## 2.3 FORIS contracts before settlement negotiations

To create Game 2, we now add the contract stage. Figure 3 shows the sequence of events in Game 2 which consists of stages 2, 3, and 4. The first event is the bargaining over a contract between P and F, represented by the rectangle in Figure 3 that is labeled with (F, P). If F and P do not make a contract, the game continues as game 1 (which has been analyzed in 2.2).

2.3.1 The subgame with FORIS contracts

If a contract has been made, this fact is revealed to D. Note that this violates the clause in the standard FORIS contract according to which the plaintiff is prohibited from revealing the existence of the contract to a third party. It is the purpose of this section to show that the revelation of this information to the defendant has a strategic impact that creates an (additional) cooperation rent between F and P.

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[20] For simplicity, we leave ties (such as $q_P Y - (1 - q_P)G = 0$) out of consideration.

Figure 2: Outcomes of Game 1

The settlement negotiations start (represented by the rectangle that is labeled as P, D). If P and D come to an agreement (the settlement payment is now denoted as S_F), then the payoffs of P, D and F are $[(1 - \mu)S_F, -S_F, \mu S_F]$.

The other consequence of a FORIS contract is the modification of the payoffs in the trial subgame, as compared to the trial subgame in Game 1: P no longer worries about the litigation costs, but now he has to share his returns with F. Hence the (expected) payoffs in case of a trial are $[(1 - \mu)q_P Y, -q_D(Y + G), \mu q_P Y - (1 - q_P)G]$.

As long as $\mu < 1$, a FORIS contract obviously turns each case into a credible threat, so P will always sue if the parties fail to settle. D faces the expected loss $-q_D(Y + G)$. P expects a gain $(1 - \mu)q_P Y$ in case of a trial, whereas a settlement brings $(1 - \mu)S_F$. Thus, P accepts a settlement payment if $(1 - \mu)S_F > (1 - \mu)q_P Y$ or, equivalently, $S_F > q_P Y$. Therefore, the bargaining range in the presence of a FORIS contract is

$$]q_P Y, q_D(Y + G)[\tag{5}$$

Due to $(1 - q_P)G > 0$, this interval is a subset of the bargaining range without FORIS contract, see (2). The FORIS contract results in an upward shift of the lower boundary of the bargaining range. The parties are predicted to proceed to court if the bargaining range (5) is empty. This is the case if $q_P Y > q_D(Y + G)$

Figure 3: Event tree of game 2
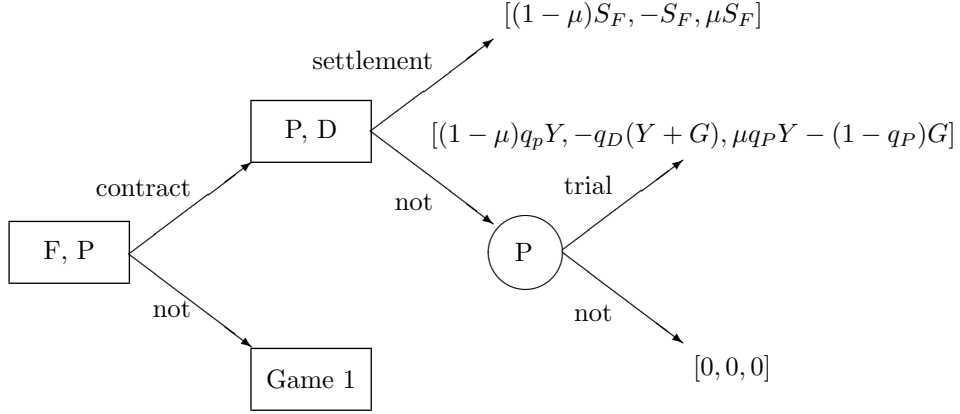
or, equivalently,

$$q_P > \frac{Y+G}{Y} q_D \tag{6}$$

If this "trial condition" holds, then the parties meet in court and the expected payoffs of P, D, and F are $[(1-\mu)q_P Y, -q_D(Y+G), \mu q_P Y - (1-q_P)G]$. If condition (6) is not fulfilled, the parties come to a settlement agreement

$$\hat{S}_F = 0.5[(q_P + q_D)Y + q_D G] \tag{7}$$

Thereby, we have derived our second result:

> **Result 2:** In the subgame of Game 2 where a contract between F and P has been made, the parties D and P
>
> - meet in court if, and only if, $q_P > q_D(Y+G)/Y$;
> - come to a settlement $\hat{S}_F$ if, and only if, $q_P < q_D(Y+G)/Y$.

Note that $\hat{S}_F > \hat{S}$.[21] We denote the difference as $\Delta S = \hat{S}_F - \hat{S} = 0.5(1-q_P)G$. Figure 4 demonstrates the two possible outcomes of this subgame of Game 2.

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[21] This relation also holds for any other distribution of the settlement rent between P and D, as long as P's share is positive.

The diagonal line represents condition (6). Combinations of q_P and q_D above this line lead to a trial, whereas parameters below this line motivate the parties to come to a settlement.

In comparison with Figure 2 there is no longer a lower rectangle where trial is a non-credible threat. As explained above, the insurance function of the FORIS contract ensures that P will always be willing to go to court, which is a necessary condition to motivate D to accept positive settlement payments.

Figure 4: Outcomes of Game 2
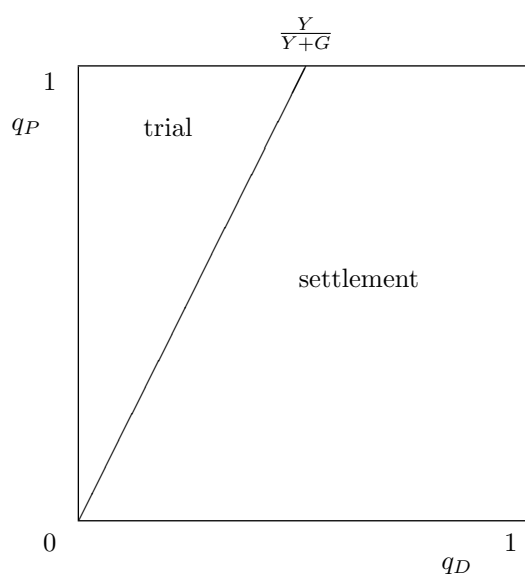
2.3.2   Incentives to make a FORIS contract

Now we compare the outcomes of the two possible subgames of Game 2, the one with a FORIS contract and the one without it, in order to derive the conditions under which it is mutually beneficial for F and P to make such a contract. Figure 5 brings together figure 2 and figure 4. According to figure 5, we have to distinguish five cases when comparing the two subgames[22]:

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[22]Note that this analysis is based on the assumption that the amount at stake, Y, is constant. If, in a comparative static analysis, Y is increased, then the intersection of the two diagonal lines with the upper boundary of figure 5 shifts to the right, and the intersection of the horizontal line shifts downwards. The slope of the shorter diagonal line remains constant, whereas the slope of the longer diagonal line decreases. Thus, a higher amount at stake c.p. increases the number of combinations of the parameters q_P and q_D that lead to trial, whereas

Figure 5: Comparison of Games 1 and 2
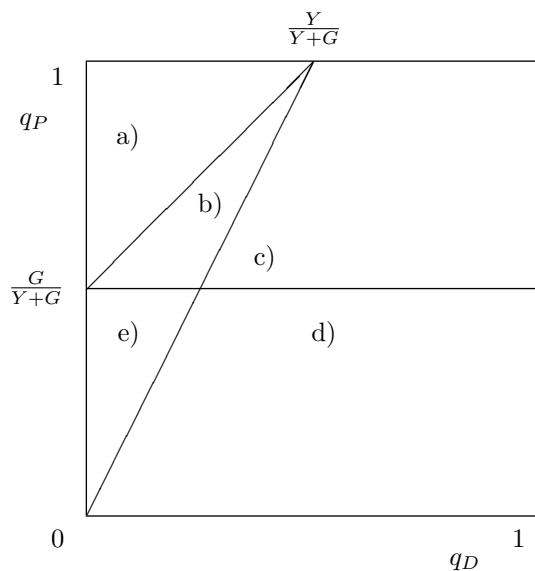
In the upper left triangle of figure 5, labeled as **a)**, both litigants are overly optimistic. Therefore, they would meet in court regardless of whether a FORIS contract has been made or not. However, the FORIS contract increases P's expected payoff by ΔS. Thus, a FORIS contract would be beneficial for P if $(1-\mu)q_P Y > q_P Y - (1-q_P)G$ or, equivalently, $\mu q_P Y < (1-q_P)G$: the agreed share for F must not be "too high". F, on the other hand, will find it beneficial to make a contract with P if $\mu q_P Y - (1-q_P)G > 0$. Obviously, there is no room for a contract between P and F. Thus, the equilibrium path under the parameters defining a) is (no contract, no settlement, trial).

The next case is represented by the small triangle labeled **b)**. Here, the parties would settle in the absence of a FORIS contract, and P's payoff would be $\hat{S}$. However, under a FORIS contract P proceeds to court, which leads to an expected payoff of $(1-\mu)q_P Y$. P finds a FORIS contract beneficial if this exceeds the settlement payoff $\hat{S}$ he receives without a FORIS contract. The condition for F to find a contract beneficial is $\mu q_P Y > (1-q_P)G$. It is easy to show that these conditions, if they are simultaneously true, imply $q_P > G/(Y+G) + q_D$, which contradicts the conditions for case b).[23] Since a FORIS contract cannot

settlements are more seldom.

[23] $(1-\mu)q_P Y > \hat{S}$ is equivalent to $\mu q_P Y < 0.5[q_P(Y-G) - q_D Y + (1-q_P)G]$. With $\mu q_P Y > (1-q_P)G$, these conditions imply $0.5[q_P(Y-G) - q_D Y + (1-q_P)G] > (1-q_P)G$, which is equivalent to $q_P(Y-G) - q_D Y + (1-q_D)G > 2(1-q_P)G$. Rearrangement leads to

be mutually beneficial for P and F under the parameter constellation b), the subgame perfect equilibrium path is (no contract, settlement $\hat{S}$).

In the upper right area of figure 5, denoted as **c)**, the parties settle in both games 1 and 2. The FORIS contract only increases the settlement result to $\hat{S}_F$ instead of $\hat{S}$. P receives $(1 - \mu)\hat{S}_F$, which is beneficial if $(1 - \mu)\hat{S}_F > \hat{S}$ or $\mu < \Delta S/\hat{S}_F$. For F, any positive share $\mu > 0$ would be beneficial. Thus, a non-empty range of values for μ exists that make the FORIS contract beneficial for both F and P. The subgame perfect equilibrium path of Game 2 therefore is (contract, settlement $\hat{S}_F$).

In the large lower right area labeled **d)**, the parties would settle if a FORIS contract has been signed. Without it, the case has NEV and therefore P's payoff is zero. Thus, any $\mu \in]0, 1[$ is agreeable to P and F. The subgame perfect equilibrium path is (contract, settlement $\hat{S}_F$).

In the small triangle **e)** at the lower left side of figure 5, the parties do not settle in either Game 1 or Game 2, but for different reasons: In Game 1, the parties do not settle since the trial has NEV. In Game 2, P would proceed to trial anyway. If F and P do not expect a settlement, then there is no bilateral gain from a FORIS contract. Thus, the subgame perfect equilibrium path is (no contract, no settlement, no trial).

The reasoning concerning cases a), b), and e) leads to our third result:

> **Result 3:** In Game 2, a FORIS contract is mutually beneficial for F and P if, and only if, the litigants P and D come to a settlement in the subsequent game. There is no cooperation rent between F and P if P proceeds to court for sure, or if neither settlement, nor trial occurs.

In the areas a), b), and e), the parties are expected to proceed to court even with a FORIS contract, an outcome that prevents the contract from being mutually beneficial for F and P. Only the parameter constellations represented by the areas c) and d) allow for the prediction that a FORIS contract would be made. In these areas, the trial condition (6) does not hold. Thus, we have derived our fourth result:

> **Result 4:** In Game 2, a FORIS contract is mutually beneficial for F an P if, and only if, $q_P < q_D(Y + G)/Y$. Then, the parties D and P come to a settlement result $\hat{S}_F$ which exceeds the settlement result without a FORIS contract, $\hat{S}$.

In case d), the FORIS contract is necessary to induce a settlement, whereas in case d) the contract only increases the settlement result. Note that the cases c) and d) include all types of plaintiffs from $q_P = 0$ up to $q_P = 1$. No value of

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$q_P(Y + G) > G + q_D(Y + G)$, implying case a).

q_P is excluded by the plaintiff's interest in a FORIS contract. Thus, a rational (Bayesian) judge cannot infer from the existence of a FORIS contract anything about the plaintiff's subjective belief regarding the chances of his case.

In the areas a), b) and e), the existence of FORIS has no impact on the outcome of the game, since P would proceed to trial after having made a contract. Again, these areas cover all possible values of q_P. Therefore, a rational judge cannot infer from the non-existence of a FORIS contract the plaintiff's type. These insights lead to our next result:

> **Result 5:** If, in Game 2, a rational judge is able to observe whether a FORIS contract has been made or not, this does not allow him to infer anything regarding the plaintiff's subjective estimation of his chances at trial, q_P.

2.4   FORIS contracts also after settlement

In 2.3, we analyzed the parameter values under which making a FORIS contract is part of the plaintiff's equilibrium behavior. In these cases, F captures a sure gain: whenever it is mutually beneficial for F and P to make a FORIS contract, a settlement is triggered and F does not actually have to bear the risk of having to pay litigation costs. However, F's position changes dramatically if potential customers are allowed to start settlement negotiations before agreeing a FORIS contract.
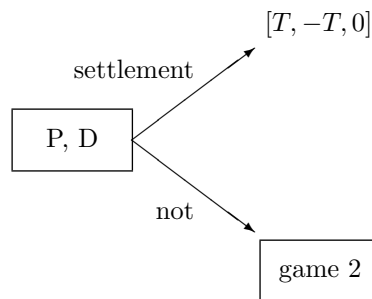
Figure 6: Event tree of game 3

Figure 6 shows the event tree of Game 3. First, the parties P and D bargain

over a settlement. If they agree upon a payment, now denoted as T, then the payoffs for P, D, and F are $[T, -T, 0]$. If the parties fail to settle immediately, then they enter Game 2 as described in the previous section. Game 2 is now a subgame of Game 3, and was already shown to have four possible outcomes:

1. In parameter constellation a) of figure 5, no FORIS contract is made and the case is resolved in court. If this is the course of action in the later game then the parties also have no incentive to settle during the first stage.

2. In parameter constellation b), the parties would later come to a settlement without making a FORIS contract. This implies that they, in the first stage of Game 3, would agree upon the same settlement as in Game 2.

3. In parameter constellation e), no contract is made, no settlement occurs and the plaintiff does not proceed to trial. Thus, there is no incentive to settle in the first round of Game 3.

4. In parameter constellations c) and d), a FORIS contract is made and a settlement is induced.

Therefore, only the parameter constellations c) and d) require further analysis in this subsection. If $q_P > q_D(Y + G)/G$ then the equilibrium path in Game 2 includes a FORIS contract and a settlement $\hat{S}_F$. Now, in Game 3, a settlement result during stage 1 (denoted as T) is bilaterally beneficial, hence acceptable, if $T < S_F$ and $T > (1 - \mu)S_F$. This bargaining range is non-empty for any value of $\mu > 0$. This leads to our final result:

> **Result 6:** In Game 3, the parties P and D have an incentive to settle in the first round if, and only if, they would settle after a FORIS contract between F and P had been made.

Thus, the mere existence of FORIS already has an impact on the parties' behavior: the opportunity to make a FORIS contract if settlement would fail in the first stage of the game provides an incentive to settle immediately, and thereby circumvent the FORIS contract. In doing so, the parties can save the share that F would collect, and distribute it among themselves. It is the shadow of the FORIS contract that shifts the settlement result upwards (from P's point of view), even when FORIS is left out of the game actually played.

3 Results and Discussion

A FORIS contract is a device that can make contingent fees compatible with fee shifting (according to the British cost allocation rule). If a FORIS contract is concluded, this turns NEV claims into credible threats and thereby induces

positive settlement payments. If the litigants were also induced to settle the case without a FORIS contract, then the contract increases the settlement result for the plaintiff. Hence, certain received wisdom about the effect of FORIS AG may be incorrect, according to which a FORIS contract only makes sense if the plaintiff does not have any money to pursue his case, or if he is totally risk-averse.[24] The truth is: in our model even a risk-neutral, wealthy plaintiff can achieve a better settlement result by concluding a FORIS contract.

If FORIS commits itself on accepting cases only before the start of the settlement negotiations, then there can be a gain from such a contract for both the plaintiff and FORIS. Without such a commitment, FORIS faces the risk of being left out of the game, while the plaintiff takes profit from the mere possibility of making a contract with FORIS. The players would come to a settlement agreement "in the shadow" of this threat, and FORIS would remain away from the equilibrium path, with zero payoff.

FORIS is obviously of interest even for a risk-neutral plaintiff. Re-allocation of risk is not the only effect of FORIS, it also has a strategic impact on settlement negotiations. This strategic impact consists of two effects: either, FORIS contracts only increase the settlement result drawn from the defendant, or (in NEV cases) the threat to sue is made credible by the FORIS contract, which is necessary to motivate the defendant to accept a settlement at all.

Hence, FORIS provides an example of strategic insurance, as well as risk-insurance.[25] However, this strategic impact requires the revelation of the contract's existence to the defendant. Therefore, this business opportunity would be foregone if FORIS observed the non-revelation clause in its standard contract.

One argument in favor of this clause is not supported by our results: this is because a rational judge is unable to infer the plaintiff's subjective probability of prevailing from the observation of a FORIS contract. However, even if it were true that the plaintiff's prospects in court could be damaged when the judge learned that a FORIS contract had been made, then perhaps FORIS should offer two types of contracts - one with the non-revelation clause, the other without it. This would leave it to the customers to make the decision between better chances in court on the one side, and a better bargaining position in the settlement negotiations on the other hand. Of course, it may also be noted that the presence of a FORIS contract may send a positive (as opposed to negative) signal about case strength: would FORIS be willing to take on cases (in practice) whose merits are so low that they expose it to significant risk? Clearly the presence of this clause warrants further examination. For instance, it would be useful to analyze explicitly the potential signaling role that the presence of a FORIS contract can have in a signaling model like REINGANUM/WILDE (1986)

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[24]See FINANZTEST (2000, 70).

[25]See KIRSTEIN (2000) who analyzes Legal Cost Insurance as an example of a "strategic insurance" for both plaintiffs and defendants. See also VAN VELTHOEVEN/VAN WIJCK (2001) on the welfare effects of Legal Cost Insurance, if its availability is limited to plaintiffs.

There are a number of other ways in which the model we have presented can be extended. To begin with, economic models of pre-trial bargaining have, since BEBCHUK (1984), assumed the presence of asymmetric information between the parties. This typically prevents cases from necessarily settling when gains from trade are present. HEYES/RICKMAN/TZAVARA (2001) analyze such a model in the presence of Legal Cost Insurance, and it would be valuable to see how the current results carry over to that setting. This would also allow for an analysis of how FORIS contracts might affect the plaintiff's credibility constraint, as analyzed by NALEBUFF (1987).

One might also ask how FORIS affects the dynamics of settlement negotiations in a model such as SPIER (1994) to examine the influence of FORIS contracts on the amount and timing of settlement.[26] It may also be fruitful to model the impact of FORIS contracts on the incentives of attorneys that represent the parties.

In our model, the starting point was a given conflict and a legitimate claim of P. Finally we should ask how the presence of an institution such as FORIS can influence the ex-ante behavior of the parties. A model that starts with the decisions that cause the conflict, taking into account the possibility of opportunistic suits, could be used to analyze whether FORIS has an impact on this underlying behavior.[27]

Clearly, the issue of Legal Cost Insurance and related institutions has considerable potential for further economic analysis. What is more, with some European countries seeking to reduce public expenditures on legal aid, and replace private insurance alternatives, the insights that such analysis may generate are likely to inform an increasingly important policy debate.

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[26]RICKMAN (1999) presents a dynamic model of pre-trial bargaining with contingent fees.
[27]See KIRSTEIN/SCHMIDTCHEN (1997) on the impact of legitimate and opportunistic suits on contractual behavior. The authors, however, do not consider settlement and insurance.

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