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Market mechanisms in dispute resolution: the position of legal expenses insurance

In this paper, I take a “law and economics”-approach to legal expenses insurance. This approach has been developed in order to analyse the economic effects of legal rules and institutions. I use it here as a positive approach, that is to make an analysis of how people behave on markets, and to predict and explain effects of certain actions.

This presentation is based on the economic models on legal expenses insurance that have been developed in the literature, as well as on empirical research. It is therefore not meant as a personal opinion, but as an overview of what has been concluded in my field of research. It is a general analysis of the topic, not concentrating on the situation in a single country. Therefore, I will not analyse in itself important differences as to process monopolies, divisions of legal costs, etcetera. In appropriate cases, however, I will refer to empirical data from various countries.

In an economic analysis a strong focus is on the incentives of parties. For example, in which respects do people behave differently once they bought legal expenses insurance? A complicating issue in this type of research is that there may be different effects, working into different directions. Often empirical analysis is needed to determine the net effect, although in some cases an intuitive assessment can be made.

In an economic analysis the criterion to judge rules and institutions is efficiency, that is to say the effect on social welfare. From this it does not follow that issues of equity (justice) are not taken into consideration. In the context of markets in dispute resolution, access to justice plays an important role. However, there are some cases in which efficiency and equity point into different directions. A positive economic analysis cannot provide the value judgment that is needed for a choice between, for example, the demands on insurability dictated by efficiency, and the equity-issue of insured's rights.

This study on legal expenses insurance consists of four parts. In order for a market to develop, demand and supply should be guaranteed. Therefore, the demand for legal expenses insurance will be discussed first. When and why are individuals or corporations seeking to buy this type of insurance? Second, the supply side of the market will be scrutinized. Under which conditions might selling legal expenses insurance be a profitable business? The third topic is the market as a whole, and in particular the effects that the availability of legal expenses insurance has on the number of disputes and the rate of settlement, and therefore on the caseloads for courts. The final part before the conclusion compares legal expenses insurance to

alternatives as state funded legal aid and contingency fees (no cure no pay).

1 The demand for legal expenses insurance

A necessary condition for markets to operate well is that they are not too “thin”. This is to say that there should be sufficient demand and supply meeting each other. I start with an analysis of the demand side of the market.

The traditional explanation for the demand for insurance is that insureds are risk-averse. This means that they are willing to buy insurance at a premium that exceeds the expected loss. Since the risk of legal costs amounts to a relatively small probability of a relatively high expense, this is indeed an important explanation for the demand for legal expenses insurance.

There is a second important reason, however. Buying legal expenses insurance allows a party to improve his strategic position in an interaction with other parties.^[1] The availability of legal expenses insurance improves this position in two ways. In the first place, it makes the threat of the plaintiff to sue more credible. In the second place the bargaining position in settlement negotiations will be improved, enabling the buyer of legal cost insurance to obtain more favourable settlements.

Some other factors could limit the demand for legal expenses insurance. There are some indications that individuals have little idea that they may be involved in a legal case, and that they underestimate this probability. They may also mistakenly believe that they are covered by legal aid or their trade union membership.^[2] Individuals may underestimate the legal expenses involved in a legal dispute as well.^[3] Individuals are also less likely to demand legal expenses insurance if they have a cheaper – or even free – alternative in the form of social insurance provided by the state.^[4] One factor in explaining the demand for legal expenses insurance in Germany is the limited availability of legal aid. When legal aid schemes in Sweden were limited, the market for legal expenses insurance grew considerably. An explanation for the fact that the United States has no developed market for legal expenses insurance is the availability of conditional fees as an alternative.^[5]

2 The supply of legal expenses insurance

In principle a market for insurance exists if some parties are less risk-averse than others. Risk-neutral parties are willing to take risks at an actuarial fair rate including costs, a price that risk-averse individuals – at least some of them – are willing to pay.

However, a number of factors might impair the insurability of events. An important part of these factors have to do with the existence of asymmetrical information, that is to say cases in which the insurer has less information than other parties.

A first issue of asymmetrical information is known as adverse selection. The propensity of an individual to buy insurance may be significantly higher if he has characteristics that make him more likely than others to bring a legal claim.^[6] This self-selection of individuals is adverse, because it singles out the customers that the insurer prefers not to attract.

The standard approach to adverse selection is individualized premium setting in the sense that the insurer determines the premium on the basis of the risk of the individual insured. Given the low premiums for legal expenses insurance, however, it is hardly worthwhile to make the costs involved. The development of larger and more balanced risk-pools is considerably easier in the case of add-on legal expenses insurance, than in the case of stand-alone policies.^[7]

A second problem of asymmetrical information is called moral hazard. Buying insurance influences the behaviour of the insured, in a way the latter knows better than the insurer does. A person holding legal expenses insurance may be much more likely to initiate a legal action than an uninsured person.^[8] Moreover, the intensity with which the policyholder will wish to pursue a claim once it has been initiated, may be much greater than the intensity a self-financing person would choose.^[9] Finally, the insured is also less inclined to monitor the billing behaviour of the lawyer employed.

There are several standard responses to moral hazard, that also work in the context of legal expenses insurance. First, the insurer can monitor the behaviour of the insured. It can refuse reimbursement of legal costs if the insured violates certain contractual provisions that have been developed in order to limit the urge of the insured to litigate. Second, it is possible to design contractual limitations to cover that have the effect that risks are shared between insurer and insured. In case of for example limited cover the insured has an incentive to limit legal costs. Third, higher premiums may be set, although this obviously has the drawback of reducing demand. A difference between adverse selection and moral hazard is

that the first might lead to a vicious circle of low risks dropping out, rising premiums, new relatively low risks dropping out, and so on, until finally the market breaks down completely. Moral hazard is unlikely to result in such a vicious circle. It should be noted, moreover, that the influence of the availability of legal expenses insurance on the rise of claims seems to be limited, and may include justified claims that would not have been brought otherwise.^[10]

A next point concerning insurability is that the number and the amount of the claims should be predictable, in order for an insurer to set the correct premiums. Partly, this problem is due to the moral hazard issues in the insurer-client relationship that were mentioned above. However, the insurer not only has imperfect information about the insured, but also about the work done by the law firm. The problem is particularly acute if both the lawyer and the client see it as being in their interest to invest more legal inputs in a case than the insurer would wish.^[11] The issue involved is quite serious, given the considerable rise in legal expenses that might result. For example, the poor profitability of legal expenses insurers on the UK market in the early 1990s is attributed to this problem.

Several responses might limit the unpredictability that results from this so-called "principal-agent problem" between insurer and lawyer. In the first place, attorneys' tariffs can be regulated strictly. If the remuneration of lawyers is closely regulated, this contributes to the predictability of legal fees. In the second place, a strategy can be chosen that is known as vertical integration. In-house personnel may be used for routine tasks, with more specialist cases being sent out to specialist law firms. In the third place, insurers might move in the direction of developing tighter control over the law firms providing them with services. A solution that fits in this approach is making a "relational" contract.^[12] A law firm is more likely to agree to perform in accordance with the needs of the insurer, if it hopes to attract future business. In this context in-house counsel has an additional role besides handling the simpler cases. Lawyers who are directly employed by the insurer are able to monitor the actions and costs of law-firms.

All the solutions mentioned in response to the issue of asymmetrical information that hamper insurability might meet legal difficulties. Process monopolies of attorneys or lawyers may limit the usability of in-house counsel. EC Directive 87/34 grants claimants a free choice of a solicitor, limiting contractual freedom between insurer and insured.

A final requirement of insurability that might be problematic is that insurers need to attract a sufficient volume of business.^[13] In the first place, this is required to ensure that insurers are more risk neutral than most individuals and therefore more efficient risk bearers. The higher the volume of business, the better risks can be spread. In the second place, economies of scale help in keeping down average administrative costs. In the third place, as competition generally is desirable from a

point of social welfare and the last two arguments point out the desirability of legal expenses insurers having a certain minimum size, the total extent of the market should be considerable.

Of course, it might be the case that a loss in social welfare resulting from a decrease in insurability is offset by considerations of equity. As stated in the introduction, however, the positive law-and-economics approach taken in this presentation does not allow a final judgment on the issue which legal rules are desirable and which not.

3 The effects of availability of legal expenses insurance

The third topic of this paper is an analysis of the effects of the availability of legal expenses insurance on social welfare.

The availability of legal expenses insurance is very likely to influence the caseload of courts. I pointed out that once legal expenses insurance has been bought, the threshold for starting a dispute is lowered. Moreover, an insured will be less likely to accept a certain offer for settlement. A superficial analysis could therefore lead to the conclusion that the availability of legal expenses insurance inevitably leads to an increase in the workload of the judicial system, an increase that generally is regarded as not desirable.

A closer look, however, shows that the net welfare effects of legal expenses insurance are likely to be positive.

A first point to be made is that the possibility to sue another party may be helpful in preventing harmful acts. One of the groundbreaking insights of law and economics is that liability for damages on the basis of for example tort or contract law has a preventive effect. If harmful acts result in an obligation to compensate the victim the perpetrator is induced to take more care in avoiding harm. For this preventive function of compensation to work optimally, however, perpetrators must be sued indeed and not be able to get away with a low settlement.

The previous observations allow an investigation of the influence of legal expenses insurance on:

1. settlement amounts

2. settlement probabilities
3. volume of accidents
4. volume of trials.

In the analysis I will talk about the plaintiff buying legal expenses insurance. Of course, in reality the defendant might buy this insurance as well. It will often be the case, however, that without legal expenses insurance the plaintiff is in a relatively weak position. The defendant may be a car insurance company, a producer, or another entity for which the costs of a legal procedure are relatively minor.

The influence of legal expenses insurance on settlement amounts is straightforward. Having insurance hardens plaintiffs' bargaining strategies in post-accident settlement negotiations and may thereby induce higher settlement offers.^[14] In accordance with the statement made on the incentives for demand for legal expenses insurance, plaintiffs who bought it are less willing to settle at a given offer.^[15]

The effects on settlement probabilities are not so easy to determine. On the one hand, the plaintiff is less likely to settle at a given offer. This effect is compensated, to a certain extent, by the fact that the defendant will offer a higher settlement amount. The net effect on settlement probabilities is hard to assess.

The volume of accidents is likely to go down. Defendants face higher expected damages to be paid. This prospect induces more care, lowering the probability of accidents. As long as the costs of additional care are lower than the benefits in terms of reduced damages, this has a positive effect on welfare. Because the expected payment of damages for perpetrators remains relatively low, the chance that legal expenses insurance leads to excessive care is negligible.

The effect of legal expenses insurance on the number of trials is ambiguous. The availability of legal expenses insurance increases ex ante care levels and, therefore, reduces accident probabilities. Should an accident and a resulting legal case arise, however, insurance may increase or decrease settlement offers, and both settlement and trial probabilities. When legal expenses insurance reduces the settlement offer, this decreases the settlement probability, but makes trial more

likely. [\[16\]](#)

Summing up, the availability of legal expenses insurance clearly generates some socially beneficial effects, since the number of accidents will be reduced. The issue, however, is whether this effect is offset by a larger number of trials. More claims will be made, and it may be the case that a higher percentage of those claims will be taken to court. Because trials are costly, there is a prima facie case for reducing their number.

In order to come to a judgment about the welfare effects of legal expenses insurance, one more point has to be taken into account. The ability of insurers to solve the principal-agent problem with lawyers and to improve the selection of cases going to court, might tip the scale. To clarify this point, some observations need to be made, relating to the optimal number of court cases.

In the absence of legal expenses insurance the number of court cases including consumers and other persons who are unlikely to be able to bear high legal expenses is probably too low. Because of the costs of court proceedings, parties generally prefer settlements over trials. From a social point of view, however, the optimal number of court cases is not zero. Even in a continental legal system court decisions – particularly those of a supreme court – have a value as precedent. However, precedents have the character of a public good. Everybody can profit from the fact that a legal issue has been clarified, including parties who did not contribute to its creation. Therefore, the incentives to realize precedents for individual parties deciding whether to settle or to sue is too low from a social point of view.

As pointed out above, buyers of legal expenses insurance may have an incentive to sue too often. The suits they initiate may include cases that have no value as a precedent whatsoever. The provider of legal expenses insurance, however, has an incentive to prevent unmeritorious cases going to court. In the first place, the insurer is likely to exclude bogus claims from its policy. In the second place, an insurer employing in-house counsel will leave the relatively simple cases to its personnel, minimizing the chances of trial by court. [\[17\]](#) The insurer has an incentive to be more lenient towards the injurer than the victim himself would have been, in order to save on its litigation costs. This incentive is limited, however, because it might harm the reputation of the company in the long run. [\[18\]](#)

On the other hand, if a case is likely to have a social benefit due the legal precedent it would set, the provider of legal expenses insurance might be interested in obtaining a court decision. As a repeat player it derives more direct benefits from setting a precedent than an individual would. For example, a clear court decision clarifying a legal issue increases the likelihood that a similar future case can be handled by in-house council rather than by more expensive lawyers outside.

4 Comparisons with alternatives

In order to be able to draw a final conclusion about the effects of legal expenses insurance, a comparison with alternatives guaranteeing access to justice has to be made. The suggestion that legal expenses insurance has a positive effect on social welfare, in itself does not exclude the possibility that some alternatives would yield a result that is even more favourable.

The most obvious candidates for a relevant comparison are state sponsored legal aid and contingent fees.

If the state provides for the costs of legal aid this has clearly the advantage of making this aid available for even the poor, who anyway are less likely to buy legal expenses insurance.^[19] It thereby can redress efficiency losses arising from the prevailing income distribution and guarantee a fundamental right to justice.^[20] The state can step in whenever the insurance market for legal expenses fails, for example because of reasons set out in the discussion on demand and supply above. Moreover, it is not realistic to expect legal expenses insurers to cover all the areas currently covered by legal aid.^[21]

For a number of reasons, however, the costs involved are hard to keep under control. It is obvious that moral hazard issues are not less of a problem than in the case of legal expenses insurance, while mechanisms to curb costs are less likely to work.^[22]

In the first place, there are more legal obstacles to cost reduction. In the second place, private insurers – especially the ones who are profit-seeking – have more incentives to save on costs than state officials. In the third place, it turns out to be the case that civil servants are less capable than personnel of legal expenses insurers in monitoring lawyers

In an empirical research on the settlement of claims, it turned out that there is evidence of longer delays when claims are legally aided as opposed to backed by legal expenses insurance. In an English report it turned out that legal aid finance increased delay by around 11% relative to legal expenses insurance, controlling for all other factors.

[23] An explanation is that claims that are legally aided are relatively immune to cost pressures. [24] The Swedish experience shows that a shift from legal aid to legal expenses insurance results in less court cases. [25]

In a system of contingency fees, or “no cure no pay”, the payment of an attorney fee is contingent on the result of the attorney’s efforts. The client only pays in case of a favourable judicial decision or out-of-court settlement. The effects of allowing contingency fees are to a remarkable extent comparable or even similar to those of legal expenses insurance. In the first place contingency fees also help to combat the principal-agent problem. The attorney has an incentive to win the case, and to do so quickly. The client can save on the costs of monitoring the attorney. In the second place, the effects on the number of trials are similar. On the one hand, access to justice is increased, resulting in more claims. On the other hand, this prospect induces perpetrators to take more care, reducing the number of accidents. Moreover, attorneys have a stronger incentive to settle cases since they are paid by outcome and not by number of hours spent. In the third place, risks are shifted to parties who are better able to assess them as well as to spread them.

Some other factors, however, tip the balance towards legal expenses insurance. A first point is that legal expenses insurance can be bought before the legal dispute arises. This avoids the problem that attorneys engage in cherry-picking by taking only the lucrative cases, leaving plaintiffs with lower chances of winning a substantial damage award without representation. A second point is that the type of cases fit for contingency fees is more or less restricted to personal injury cases and anyway more limited than the types of legal disputes for which legal expenses insurance provides cover. A third point is that under contingency fees the claimants may be bearing the cost of the fees, resulting in a lower final amount than under legal expenses insurance. [26] A final point is that legal expenses insurance is less vulnerable to principled objections like the one that anyhow attorneys should not have a personal stake in the outcome of a case.

5 Conclusion

The availability of legal expenses insurance is likely to have a positive effect on social welfare. It induces more care by potential perpetrators and providers of legal insurance function as gate-keepers avoiding unmeritorious cases going to trial.

To a large extent the welfare effects of legal expenses insurance are in line with the equity argument that individuals should have access to justice.^[27] Individuals are enabled to start a legal procedure and to refuse an unfair settlement.

For the market for legal insurance to operate well and indeed yield a positive effect on social welfare sufficient incentives for the demand and supply of this insurance should exist. The main issue concerning supply is the insurability of legal expenses. This requires predicatability of those expenses, which can be promoted by public regulation of lawyer's costs or by leaving contractual freedom to insurers to curb these costs.

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