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TPF AND ITS ALTERNATIVES: AN ECONOMIC APPRAISAL

Jef De Mot, [Michael Faure](#) & [Louis Visscher](#)

1. Introduction

In many legal systems there is increasingly a variety of techniques which are developed to promote access to justice. It can be argued that from society's perspective, promoting access to justice fulfils an important goal, not only from the point of view of social justice (providing victims-plaintiffs with the opportunity to enforce their rights), but also from an economic angle. Limits on access to justice may lead to a situation whereby social costs are thrown on society at large and not sufficiently internalized. It is therefore no surprise that in many legal systems a variety of techniques has been developed or is in full development in order to encourage access to justice, particularly for plaintiffs who may have meritorious claims but who simply are not in the financial position to bring their claim.¹ Moreover, encouraging access to justice is also a way of stimulating private enforcement of laws, which is high on the policy agenda in many jurisdictions.²

It is in this context also that third party funding of litigation has emerged. From an economic perspective, third party funding can be considered as a remedy for cases where individuals do not bring claims because they do not possess sufficient funds to bring the claim, and do not have access to other ways of financing their claim. It can also mitigate the market failure that can occur in cases of so-called dispersed losses, where rational apathy may occur.

So far third party funding (TPF) has mainly been developed in the US, the UK and Australia. A variety of different models exists. In some cases TPF firms invest in commercial lawsuits; in others they provide loans or credit to law firms that represent plaintiffs and in yet a third situation funding is provided directly to individual plaintiffs.³ Usually TPF focuses on supporting plaintiffs' claims; it is so far not (or rarely) focused on funding defendants, although that may develop in the future as well.

1 For an overview of the literature, *see inter alia* the contributions in M Tuil and L Visscher (eds), *New Trends in Financing Civil Litigation in Europe. A Legal, Empirical and Economic Analysis* (Cheltenham: Edward Elgar, 2010).

2 *See* further F Weber and M Faure, 'The Interplay between Public and Private Enforcement in European Private Law: Law and Economics Perspective' (2015) 4 *European Review of Private Law* 525-550.

3 *See* further D Mayers and CW Smith, 'On the Corporate Demand for Insurance' (1982) 55(2) *Journal of Business* 281.

The goal of this article is to discuss TPF and (some of) its alternatives from an economic perspective. We start by explaining why TPF emerges and by illustrating that TPF can to a large extent cure the market failure which would result from incomplete access to justice (II). As we will argue, there are a number of different effects of TPF, which could be formulated in terms of advantages and disadvantages. Those relate strongly to the effects of the funding by a third party on the incentives of the parties involved in the litigation. We will attempt to illustrate those effects on the behaviour of the litigants (III). Of course we do realize that TPF may not be the only solution to the problems with which plaintiffs are confronted. An interesting alternative is legal expenses insurance (LEI). A comparison of TPF and LEI will be undertaken in IV. Yet another alternative would be to make the remuneration of the lawyer (or another party representing the plaintiff) dependent upon the outcome of the case. The latter is typically known as a contingency fee arrangement and could equally protect plaintiffs against their risk aversion. There are, however, particular differences in the way TPF and contingency fees function and more particularly how they affect the behaviour of the litigants (V). Section VI concludes.

2. Why TPF Emerges and Obstacles for Its Growth

In this general section we will sketch why, from the perspective of society and plaintiffs, one could expect a demand for TPF. Hence, we will focus on the gaps concerning access to justice that TPF could fill (A). At the same time it is surprising that, as we mentioned in the introduction, TPF is still largely a common law phenomenon, notwithstanding increasing interest in many European jurisdictions as well. It is also common in international investment arbitration. That raises the question whether, from a law and economics perspective, there could be particular features that explain the slow development of TPF (B).

2.1 Why TPF Emerges

As we mentioned in the introduction there are many cases in which a civil lawsuit will not be filed although the potential damage could be large. First and foremost, the plaintiff may simply lack sufficient funds to initiate a lawsuit. Second, the total damages may be large but dispersed. One may think of environmental harm potentially leading to large social losses. However, if the loss is spread over a large number of victims, some may even consider environmental harm as “victimless”. The result is that no one will bring a lawsuit. Another

example could be the one where someone concludes a contract with a bank, receives poor advice, and as a result suffers a loss of, say, € 4.000,-.⁴ In such a case the plaintiff could start proceedings against the bank, but the outcome is highly uncertain. Moreover, it is also unknown how much the procedure would cost in legal fees and there is a large probability that the lawyers' fees could be higher than the total benefit in the event of winning the trial (€ 4.000,-).

In such cases the plaintiff will often take the rational decision not to bring a lawsuit. In the first case it may simply be because he or she is not able to do so. In the second case the reason may be that no victim feels sufficiently harmed in order to bring a suit; in the third case the plaintiff may be discouraged from bringing a lawsuit, given the relatively high costs involved in litigation. In addition to the fees that would have to be paid to the lawyer, the plaintiff will also take into account the time involved in the case. From an economic perspective those are opportunity costs that will have to be taken into account as well. In the second case no lawsuit will be filed at all because the damage is felt collectively but not (or barely) by one individual plaintiff; in the third instance a consumer may take the rational decision not to pursue the case given high aversion against the risk of being confronted with high costs. The problem is, moreover, that the plaintiff will have to incur the costs of a trial before he can obtain compensation. The possibilities for the plaintiff to obtain financing for these costs may be limited, so he would not be able to bring a lawsuit simply because he cannot afford to pre-finance the costs of the trial. As such the decision of the plaintiff not to bring suit is rational and in the literature described as the problem of "rational disinterest" or "rational apathy".⁵

The result is therefore that in those examples, plaintiffs will not bring a lawsuit, even though a serious social loss is produced. From an economic perspective this is a problem for the simple reason that an externality is created: a cost is thrown on society and not borne by the one who causes the loss (the polluter in the first example; the bank in the second). Since the externality is not internalized, the social costs created will not be incorporated in the prices of the products or services brought on the market by those producers, leading to a market failure.

4 The example comes from M Faure, 'CADR and Settlement of Claims – A Few Economic Observations', in C Hodges and A Stadler (eds), *Resolving Mass Disputes, ADR and Settlement of Mass Claims* (Cheltenham: Edward Elgar, 2013) 39-40.

5 For details see H-B Schäfer, 'The Bundling of Similar Interests in Litigation. The Incentives for Class Actions and Legal Actions Taken by Associations' (2000) 9 *European Journal of Law and Economics* 183.

These simple examples show that barriers to justice can create a market failure. The flipside is obviously that lowering barriers to justice can be socially beneficial as this will lead to a potential internalization of an externality.

It is precisely here that TPF can potentially play a role. The first example speaks for itself. The second example is clearly not one where (only) the problem of risk aversion against high costs (or simply the lack of funds on the side of plaintiffs) plays a role. In the second example (where the damage is widespread), no victim suffers damage large enough to have an incentive to bring a lawsuit. These cases thus provide a strong argument for another type of solutions, being some form of collective action or representative action whereby another organization (e.g. a trustee or an NGO) would bring a suit and represent those who have been harmed. This would also provide the justification for class actions e.g. in the case of consumer suits.⁶ One possibility for solving the above-mentioned problem is thus to collectivize the interests and to bundle them into one claim. TPF may still play a role in that context, for example when financing is sought for a group litigation which could otherwise not be brought.⁷ But the primary solution in the case of the second example (widespread environmental losses) is clearly to allow some kind of bundling of claims or to allow someone to represent the damaged (environmental) interest.

In the third example (the misleading bank case), TPF may be a way of dealing with the aversion of the plaintiff against bringing a suit. For the risk-averse consumer the major advantage of TPF would be that the TPF organization finances the litigation and takes over the risk, of course in exchange for a part of the proceeds in the case where the litigation is successful. In that sense it is relatively easy to argue that TPF may be beneficial both from society's perspective and for potential plaintiffs. For the plaintiff, TPF may provide a remedy for risk aversion and thus allow the plaintiff to bring a suit which he otherwise would not bring. This is at the same time also advantageous for society: a meritorious claim which would otherwise not be brought can now be successful. Hence the market failure resulting from the high barrier to justice, and consequently lacking internalization of an externality, is solved.

Obviously TPF is not the only instrument that can deal with this particular problem. An alternative may be legal expenses insurance (LEI) or a contingency fee arrangement.

6 See further on class actions A Stadler, 'Group Actions as a Remedy to Enforce Consumer Interest', in F Cafaggi and HW Micklitz (eds), *New Frontiers of Consumer Protection – The Interplay between Private and Public Enforcement* (Antwerp: Intersentia, 2009) 305-317.

7 See further DR Hensler, 'Financing Civil Litigation: The US Perspective', in M Tuil and L Visscher (eds), *New Trends in Financing Civil Litigation in Europe – A Legal, Empirical and Economic Analysis* (Cheltenham: Edward Elgar, 2010) 153.

Although both LEI and contingency fees can indeed remove barriers to justice as well, the discussion of those two instruments (in sections IV and V) will show that there are particular reasons why TPF may be relatively attractive and so can have an added value compared to LEI and contingency fees. One problem is that many individuals may not take LEI for a variety of reasons; also, contingency fees may not provide a solution in all cases. Another problem is that lawyers themselves can in some cases be risk averse, especially when large up-front financing would be required with an uncertain outcome.

2.2 Obstacles

Although we have just argued that TPF may have substantial advantages both for individual plaintiffs as well as for society, it is striking that, as we mentioned in the introduction, TPF is, at least in the European context, hardly developed and has so far merely remained a common law phenomenon. One reason is that many legal systems are opposed to third parties funding a claim. Obviously there may always be interest group explanations that could be examined when one notices that particular potentially beneficial instruments and institutions do not emerge. However, at this stage we will not examine which interest groups may be behind raising barriers to introduce TPF in Europe; we will rather use law and economics to examine whether there may theoretically be public interest reasons that could explain why TPF has not emerged to the extent that one would imagine. Obviously, with litigation sponsored by a third party, the question will always arise of whether such a funding mechanism could lead to the well-known problems of adverse selection, moral hazard or free riding. These are generally examined within the context of insurers taking over risks, but obviously play a role at a more general level as well, when a third party finances litigation. We will hence examine these issues in turn; in section IV we will examine how these issues (more particularly adverse selection and moral hazard) compare in the case of TPF to LEI.

2.2.1 Adverse Selection

Adverse selection generally refers to the danger that a particular instrument which transfers risk (such as insurance or TPF) would be especially attractive for high risk individuals. If that were the case and if the TPF funder were not able to adequately distinguish good risks from bad risks, the danger could emerge that the TPF funder remains with only the high risk cases. This could endanger the financial viability of the TPF system. This problem could normally

be resolved if TPF funders were to carefully screen the plaintiffs seeking TPF and so would only finance meritorious suits. The problem may however arise that the marginal costs of screening are relatively high compared to the value of litigation as a result of which the TPF funder would refrain from a detailed screening. This can for example be the case in some consumer cases.

Adverse selection is, as has been stressed by Noble Prize winner Akerlof, the result of an information asymmetry, here between the consumer seeking TPF and the TPF funder.⁸ The problem will thus emerge particularly when it is difficult for the TPF funder to assess the quality of the claim and consumers have better information but do not communicate their information to the TPF funder. This may be an issue in small consumer loans. However, if TPF funders have a substantial amount of claims which they finance, they could come to a reasonable spreading of the risk.

An additional problem in this respect in the European context is that in most European legal systems contingency fees (see below under V) are prohibited.⁹ A combination of TPF and contingency fees may be beneficial to cure adverse selection. The fact that an attorney accepts a case on a contingency fee basis indeed implies that the attorney as gate keeper has verified the merits of the case.¹⁰ The fact that the attorney accepts the case on a contingency fee basis could thus provide a positive signal to TPF funders and could remedy adverse selection. The fact that contingency fees are largely prohibited in Europe could hence be one of the explanations for the relatively low occurrence of TPF, because of the reduced possibility to signal case quality.¹¹ This could also lead to the policy recommendation that if a policy maker considered stimulating TPF as a valuable instrument for lowering barriers to justice, then this could be combined with a contingency fee system, as this might reduce the risk of adverse selection.

It should, moreover, be mentioned that this adverse selection risk may be relatively high in the market for funding consumer claims where information asymmetry between the potential plaintiff and the funder may be high. As we mentioned in the introduction, TPF can also apply to commercial firms where the value at stake can be substantially larger. This implies at the same time that the relative benefits of detailed screening increase as well. As soon as the

⁸ See generally G Akerlof, 'The Market for "Lemons": Quality, Uncertainty and the Market Mechanism' (1970) *Quarterly Journal of Economics* 488-500.

⁹ For details see M Faure, F Fernhout and N Philipsen, 'No Cure, No Pay and Contingency Fees', in M Tuil and L Visscher (eds), *New Trends in Financing Civil Litigation in Europe. A Legal, Empirical and Economic Analysis* (Cheltenham: Edward Elgar, 2010) 33-56.

¹⁰ As under a contingency fee arrangement the attorney in fact has to pre-finance the claim.

¹¹ Disregarding for the moment the fact that some legal systems may have formal prohibitions.

amounts at stake are larger, TPF firms would have a stronger incentive to screen ex ante and thus reduce adverse selection.

2.2.2 *Moral hazard*

Moral hazard in litigation can refer to the phenomenon that the behaviour of the litigant (plaintiff) will change as a result of him no longer being exposed to risk. The problem could more particularly emerge that when the litigation is integrally funded by a third party on the one hand, the incentives to bring also unmeritorious suits may increase (that is largely a problem of adverse selection), but the problem could equally arise that during litigation the plaintiff will show behaviour which is no longer welfare maximizing since he is no longer exposed to any risk. This could then for example refer to reduced incentives for cooperating optimally during the trial e.g. with a view on truth finding.

Just as with insurance also, in this case the classic remedies for moral hazard could apply. The remedy for moral hazard could on the one hand constitute control of the behaviour of the litigant by the TPF funder through adequate monitoring. That detailed monitoring is, however, costly. The cheaper solution is still to expose the litigant partially to risk. As a result the litigant will always have incentives to cooperate with the TPF funder to some extent.¹²

As a result one can hold that TPF, like any other mechanism that removes risk from a plaintiff may create moral hazard, but that on the other hand adequate remedies are advanced in the literature to cure moral hazard.¹³ As long as those remedies are applied (either monitoring or still exposing the litigant to risk, or a combination of the two) moral hazard could in principle be adequately remedied.

2.2.3 *Free-riding through TPF?*

Another problem advanced in the literature is that TPF, like other forms of funding litigation, could lead to the situation whereby positive externalities are created for third parties, more particularly society at large. Other individuals would benefit from TPF since TPF can

¹² Of course the plaintiff only bears a part of the costs and may weigh this against the efforts of cooperating. The incentives to cooperate may therefore be less than when the plaintiff was exposed to the full costs. Still, a partial exposure to costs can at least partially remedy the moral hazard risk.

¹³ See in this respect more particularly S Shavell, 'On Moral Hazard and Insurance' (1979) *Quarterly Journal of Economics* 541-562.

additionally lead to more deterrence of potential tortfeasors (since more claims will be brought) but the other individuals will not have to pay for TPF. They could therefore enjoy this positive externality without paying for it. That could in theory create a free-riding problem as a result of which TPF would not emerge. This refers to the problem that people other than the litigant may benefit from the deterrent effect created through TPF.¹⁴ Under TPF a problem might arise if TPF were focusing on a particular category of claims. If those claims were successful the result would be that internalization takes place, but that fewer claims would take place in the future, as a result of which TPF companies may lose business. If that scenario were realistic there would be a danger that TPF companies would provide a sub-optimal amount of TPF, out of the fear that TPF would precisely have the socially beneficial effects of reducing the need for claims, thus reducing the business of TPF companies. However, this story may only be true in a monopolistic market. One could eventually expect that if this problem were real the TPF companies would prefer to invest in those types of claims that are difficult to deter, because that would in the end not affect the possibilities of future claims (and hence more business) for the TPF industry.

Obviously, the extent to which the TPF industry would really adapt its behaviour in that sense is an empirical matter; it may in the end be rather theoretical that TPF companies would act in this way (funding fewer claims in order to keep future income streams). It is an issue which also to some extent plays a role in the insurance industry. Insurers on the one hand may have incentives to reduce moral hazard and keep accident rates down. On the other hand, the higher the liability, the higher the demand for liability insurance is as well. This brought Kip Viscusi to note that “in the long run the insurance industry will profit from a high level of liability since that will increase the degree of coverage it can write”.¹⁵

2.2.4 *Summary*

Summarizing: there may be a danger of adverse selection with TPF, but screening by the funder will reduce this problem. Also, a system of contingency fees could ameliorate this, since contingency fees could signal the quality of the case to the TPF funder. Moral hazard could theoretically play a role, but adequate remedies against moral hazard can be employed by TPF funders, as a result of which this should not be a major issue. Also the danger that

14 For a more detailed account see M Faure and J De Mot, ‘Comparing Third-Party Financing of Litigation in Legal Expenses Insurance’ (2012) 8(3) *Journal of Law, Economics and Policy* 765-768.

15 See WK Viscusi, ‘The Dimensions of the Product Liability Crisis’ (1991) 20 *Journal of Legal Studies* 147-148.

positive externalities and free-riding may reduce the demand for TPF does not seem to be a serious danger. The only issue that (again theoretically) could arise is that TPF funders would select the cases in such a way that they still could guarantee a future income stream.

However, as indicated, most of those obstacles can to a large extent be remedied through adequate measures and could in that sense not seriously limit the development of TPF. So, from an economic perspective, there are no serious arguments against employing TPF on a larger scale. The reasons why TPF is not used more than it could be (at least in Europe) may therefore possibly be due to resistance for other reasons.

We will now proceed to a more detailed analysis of TPF, analysing the effects of TPF on the behaviour of the litigants. That will also shed some light on the potential advantages and disadvantages of TPF.

3. Advantages and Disadvantages of TPF

We will first analyze the potential influence of TPF on the volume of litigation (A); next we will examine how TPF could affect the quality of litigation and settlements, given the different incentives generated through TPF (B); we further proceed with the question of how the incentives provided through TPF affect the timing of settlement (C). Finally we examine the influence of TPF on the costs of (individual) disputes (D).

3.1 The volume of litigation

It is often claimed that TPF will increase the number of lawsuits.¹⁶ For example, in the context of business litigation disputes, without TPF a business-plaintiff will compare the internal cost of capital with the expected return from filing a lawsuit. Only if the expected return is large enough will the plaintiff be willing to file the suit. If the expected cost of TPF is lower than the internal cost of capital, then the amount of litigation instigated by business-plaintiffs will increase.¹⁷ This cost-reducing effect may also reduce the settlement surplus: when the plaintiff's or defendant's costs of trial decrease, the settlement surplus becomes smaller. This leads to more trials, given that one of the reasons that parties settle is to avoid the costs associated with litigation.

¹⁶ See J Beisner, J Miller and G Rubin, U.S. Chamber Inst. for Legal Reform, *Selling Lawsuits, Buying Trouble: Third-Party Litigation Funding in the United States* 2-3 (2009).

¹⁷ See PH Rubin, 'Third-Party Financing of Litigation' (2011) 38 *Northern Kentucky Law Review* 676.

Obviously, also when plaintiffs are individuals TPF can increase the volume of litigation. This is true even for countries like the United States where plaintiffs can often rely on contingency fees to finance litigation. There are cases with positive expected value which individual attorneys or law firms are unwilling to take on a contingency fee basis because of the large risk involved (e.g., large class actions).¹⁸ Furthermore, due to limits on economies of scale, litigation in many very large cases is not feasible. In this context, third-party financing can fill a gap¹⁹ since there are larger economies of scale in finance than in litigation.²⁰ An empirical study found that the volume of litigation increased in Australia after it allowed the free sale of lawsuits,²¹ which may give some credibility to the economies of scale theory.

Others are more sceptical that the volume of litigation will necessarily increase.²² First, the fact that TPF allows more claims to be brought or to be fought more intensely increases the deterrence of socially undesirable behaviour that could lead to lawsuits. Hence, TPF could lead to less unlawful behaviour and hence fewer grounds for lawsuits. As a consequence, the *ability* to pursue litigation does not unequivocally increase *actual* litigation.²³ Second, the existing empirical study mentioned above relies on small sample sizes (five to seven observations), so more empirical research is absolutely necessary. Third, whether TPF will significantly increase litigation may differ from country to country, depending on the (other) instruments presently available in that country to increase access to justice, and on the predictability of legal costs. For example, the resulting increase in litigation could be substantially larger in Europe than in the U.S. if the reason why some lawsuits are at present not filed, is not because of a lack of capital, but because of a lack of additional potential claims that contingency fee lawyers are willing to litigate²⁴, given that contingency fees are

18 The risk can be so vast that losing such a case could lead to bankruptcy of the law firm.

19 See M Abramowicz, 'On the Alienability of Legal Claims' (2005) 114 *Yale L.J.* 697, 739.

20 See Rubin, *supra* note 17, at 677, writing that "Limits on economies of scale will constrain the size of plaintiff-oriented law firms, which in general seem to be smaller than defendant-oriented firms, so that litigation of many very large cases simultaneously is not feasible. It is in this situation that third-party financing would be most useful. This is because such financing can separate the financial decision from the decision to litigate. Large financial investment firms could invest in several high-value, high-risk cases and have the cases litigated by separate law firms. In other words, there are greater economies of scale in finance than in litigation."

21 See DL Chen and DS Abrams, A Market for Justice: The Effect of Third Party Litigation Funding on Legal Outcomes, at 9-11 (2011), available at <http://www.duke.edu/~dlc28/papers/MktJustice.pdf>.

22 See S Garber, *Alternative Litigation Financing in the United States: Issues, Knowns and Unknowns* (Santa Monica CA: Rand Corporation, 2010) 29.

23 See also D Dana and M Schanzenbach, How Would Third Party Financing Change the Face of American Tort Litigation? The Role of Agency Costs in the Attorney-Client Relationship (9 (2009), available at http://www.law.northwestern.edu/searlecenter/papers/Schanzenbach_Agency%20Costs.pdf (paper presented at Searle Public Policy Roundtable on Third Party Financing of Litigation, , Chicago, Ill. September 24–25, 2009).

24 See, e.g., HM Kritzer, 'Contingency Fee Lawyers as Gatekeepers in the Civil Justice System' (1997) 81 *Judicature* 22.

prohibited in many European countries (and public support for legal aid is being reduced in some European countries and many households do not have legal expenses insurance).

The conditions needed for TPF to increase litigation may strongly depend on the type of TPF segment involved.²⁵ In the context of loans to plaintiffs' law firms, an increase in the volume of litigation is plausible if firms use the funds to take on more clients rather than smoothing their cash flow or working more on the cases in their portfolio.²⁶ With respect to investments in commercial claims, the number of claims may increase substantially where the economics of a claim are interesting to a TPF supplier, but companies are not able, or do not want, to use internal capital to pay hourly legal fees and cannot find a law firm willing to represent them in exchange for a contingency fee. Because there are many uncertainties surrounding these conditions, the force of the effect in this segment is difficult to forecast. For example, it is not known whether the level of demand for legal services based on contingency fees in commercial litigation is larger than the supply or not. If it is, there could be a substantial demand for TPF in this segment.

3.2. The quality of litigation and the quality of settlements

Some scholars think that TPF will increase the number of lawsuits with no or dubious legal merit²⁷, because plaintiffs (and their lawyers) are more willing to bring such lawsuits if they are not fully paying for these cases themselves. However, it is not very plausible that consumer legal funding will substantially increase the number of cases without merit. Such loans are typically less than 10 percent of the estimated recoveries in the lawsuits at hand.²⁸ With respect to loans to law firms, TPF suppliers do not want to lend to firms who hold many claims with a small probability of victory, given that the suppliers do not share in the upside potential of these claims. The exact effect on the quantity of lawsuits with low probabilities will depend on the due diligence processes. The situation of investments in commercial claims could be different. For these claims, TPF suppliers do share in the upside potential of the claim. Since some low-probability suits have high expected profits, TPF suppliers may be willing to invest in some of these cases.

²⁵ See Garber, *supra* note 22, at 29-30.

²⁶ Obviously, this will increase the costs of individual cases.

²⁷ See *e.g.*, Beisner, Miller & Rubin, *supra* note 16, at 2-3.

²⁸ See Garber, *supra* note 22, at 30.

Not all scholars agree that the effect on the amount of low-probability cases will be substantial.²⁹ First, TPF suppliers seem to find plenty of investment opportunities among claims with quite high chances of recovery. Second, investing in claims with high probabilities of recovery may be a good strategy from a risk-management perspective. It seems that the TPF investors are not sufficiently capitalized to have enough cases so that their portfolio risk is negligible. Juridica, for example, reportedly does not accept claims “that raise novel legal questions or that will probably end up before a jury.”³⁰ Naturally, this could change in the future. For now, large capital providers such as banks and insurance companies often have stayed away because of the legal uncertainty associated with litigation funding.³¹ If this uncertainty fades, investing in nuisance suits may become a profitable business model for these corporations. Also, because of the high rates of return that TPF companies currently receive, new capital may be attracted into the market. Meritless lawsuits will increase if suppliers without the necessary knowhow to evaluate complex cases enter the market. It can be expected however that these suppliers will eventually leave the market, because investing in meritless cases will lead to substantial losses in the long run.

Asymmetric risk preferences may distort settlement amounts. A defendant who faces many suits from different plaintiffs can expect to settle many cases below the average damages award. While the repeat player defendant can pool the litigation risks, the one-time plaintiff will be more fearful of the worst case scenario. The problem may be especially relevant in personal injury lawsuit litigation, where the spread of possible damages is large and the difference between the ability of the parties to manage litigation risk is vast.³² Thus, settlements may more often reflect bargaining power than actual legal merit. Third-party financing levels the playing field between plaintiffs and defendants and thus leads to more accurate settlements.³³ However, it is uncertain to what extent the availability of TPF presently has an effect on the accuracy of settlement amounts. For example, investment funds only invest in large commercial claims, and refuse smaller claims or personal injury claims held by individuals. Regarding consumer loans, high interest rates and the fast accumulation of interest may take away much of the value of this type of TPF.³⁴

²⁹ See *id.* at 32.

³⁰ See JD Glater, ‘Investing in Lawsuits, for a Share of the Awards’ *N.Y. Times*, June 3, 2009, at B1.

³¹ See JT Molot, A Market Approach to Litigation Accuracy, at 24 (Geo. Univ. L. Ctr., 2009), available at http://www.law.northwestern.edu/searlecenter/papers/Molot_Accuracy.pdf, at 32.

³² See JT Molot, ‘Litigation Finance: A Market Solution to a Procedural Problem’ (2010) 99 *Geo. L.J.* 85.

³³ *Id.*

³⁴ Under these loans, consumers pay interest, not a part of the judgment they receive in the case of a plaintiff victory.

3.3. *The timing of settlements*

With TPF, a defendant may be more willing to settle a claim at an earlier stage.³⁵ There are a number of reasons for this. First, the defendant's bargaining power may decrease because a defendant who knows that the plaintiff's claim is financed may become conscious that certain threats made during the negotiations are not credible any longer. Also, the fact that a TPF supplier has agreed to fund a case can be seen by the defendant as a signal that the case is of relatively high quality. An empirical study by Fenn and Rickman has shown that meritorious cases settle earlier. They found that the more the defendant thinks he is liable, the shorter the settlement delays.³⁶ They also established that cases, in which insurers believe that their policyholder is fully responsible, lead to faster settlements.³⁷ Finally, they discovered that cases in which a hospital at first believes it is not liable, are settled much slower compared to cases where the hospital originally believes it is liable.³⁸ Furthermore, when new information arrives which weakens a hospital's case, the settlement process is accelerated. That signal may be especially important for investments in commercial claims because of the scrupulous due diligence processes.³⁹ TPF would however cease to signal case quality if investing in nuisance suits were to become an attractive business model for TPF companies. In the context of consumer legal funding, TPF may decrease the incentive of a plaintiff to settle early, because the loans allow plaintiffs to pay their bills in the interim. Also, TPF may sometimes cause a plaintiff to be unwilling to settle late in the life of the claim, because the amount owed to the funder can ultimately exceed what the defendant is willing to offer as a settlement amount. The plaintiff may then favour going to trial, hoping that the court will grant an award that is larger than the one owed to the funder. During the time between the start and the later stages of the settlement process, consumer legal funding may lead to faster settlements due to the fast rate at which a plaintiff's debt to the funder grows. Likewise, a law firm paying interest on a loan may want to settle relatively early so it can repay its debt from the proceeds.

35 See Garber, *supra* note 22, at 32-34.

36 P Fenn and N Rickman, 'Delay and Settlement in Litigation' (1999) 109 *Econ. J.* 487.

37 P Fenn and N Rickman, 'Asymmetric Information and the Settlement of Insurance Claims' (2001) 68 *J. Risk & Ins.* 627.

38 P Fenn and N Rickman, Legal Liability and the Timing of Settlement in Medical Malpractice 21 (American Law & Economic Association Annual Meetings, Paper No. 44, 2005), available at <http://law.bepress.com/cgi/viewcontent.cgi?article=1543&context=alea><http://law.bepress.com/cgi/viewcontent.cgi?article=1543&context=alea>.

39 See Garber, *supra* note 22, at 26.

3.4 *The costs of (individual) disputes*

One important effect of TPF is the relaxing of budget constraints.⁴⁰ At first sight, one may think that TPF will always increase the costs of individual disputes because cash-constrained plaintiffs tend to invest less in out-of-pocket expenses (e.g., expert consultants and witnesses). However, when one uses rent seeking theory to examine how the relaxing of budget constraints influences the litigation expenditure of the parties, this result becomes less obvious.⁴¹ In contrast to what intuition may suggest, relaxing budget constraints does not always increase litigation expenditure. Due to strategic interaction between the parties, expenditure under TPF may either decrease or increase. Interestingly, expenditure is more likely to decrease for meritorious suits and more likely to increase for relatively weak cases. The reasoning behind this result is the following. For weak claims, when the plaintiff spends more due to vanishing budget constraints, the case becomes closer⁴², and it becomes more valuable for the defendant to spend additional resources as well. For relatively strong claims, when the plaintiff spends more, the case becomes even less close⁴³ and it becomes less worthwhile for the defendant to spend more.

Furthermore, the extent to which TPF will influence the costs of individual disputes depends on whether funders are able to influence how cases are pursued. Unfortunately, much is unknown here.⁴⁴ With respect to investments in commercial litigation, the influence on expenditure depends to a considerable extent on the share of the recovery and the costs for the funder.

40 See e.g. DS Abrams and DL Chen, 'A Market for Justice: A First Empirical Look at Third Party Litigation Funding' (2013) 15 *U. Pa. J. Bus. L.* 1075.

41 Rent seeking models are increasingly used to study the behaviour of litigants during trial. See e.g. A Katz, 'Judicial Decision-making and Litigation Expenditure' (1988) 8 *International Review of Law and Economics* 127-143; A Farmer and P Pecorino, 'Legal Expenditures as a Rent-seeking Game' (1999) 100 *Public Choice* 271-288; J Hirshleifer and E Osborne, 'Truth, Effort and the Legal Battle' (2001) 108 *Public Choice* 169-195; J De Mot, 'Comparative versus Contributory Negligence: A Comparison of the Litigation Expenditures' (2013) 33 *International Review of Law and Economics* 54-61; F Parisi and B Luppi, 'Litigation as Rent-seeking', in RD Congleton and AL Hillman (eds), *A Companion to Rent Seeking: Theory and Practice* (Cheltenham: Edward Elgar, 2015); J De Mot, B Luppi and F Parisi, 'Are Sequential Trials Really Better than Unitary Trials?', working paper (2015); J De Mot and ThJ Miceli, 'Comparing All-or-Nothing and Proportionate Damages: A Rent Seeking Approach' (2015) 11(1) *Review of Law & Economics* 1-17. These models add reality to the economic theory of litigation. They have delivered several theoretical results which have been empirically confirmed.

42 The total arguments in favor of the plaintiff are moving closer to the threshold of the standard of proof.

43 The total arguments in favor of the plaintiff are moving further away from the threshold of the standard of proof (in the direction favorable for the plaintiff).

44 See Garber, *supra* note 22, at 35.

4. A Comparison with Legal Expenses Insurance

As we have already mentioned in the introduction, TPF is one technique of funding litigation and removing risk from risk averse litigants, especially plaintiffs. However, alternatives exist. One prominent example is legal expenses insurance (LEI). The question arises of whether TPF may have some advantages compared to LEI. We will try to analyze this question by focusing on the same issues analyzed before, namely how LEI affects the volume of litigation (A), the quality of litigation and settlements (B), the timing of settlements (C) and the costs of individual disputes (D).

4.1 *The volume of litigation*

Legal expenses insurance can increase the amount of litigation for several reasons. To start with, an insured person may face more justiciable incidents due to moral hazard. However, empirical research has shown that the effect of moral hazard in this context is relatively small.⁴⁵ Second, given a justiciable incident, LEI makes it easier to undertake legal action. A victim may now be willing to pursue a claim with negative expected value because the insurer pays (a part of) the cost.⁴⁶ Note however that not all costs are externalized to the insurer (e.g. psychological costs and the opportunity cost of time). Third, LEI allows risk-averse plaintiffs to file suits they would otherwise not have filed, as they now bear only part of the litigation cost risk. Fourth, plaintiffs with insufficient funds may now bring a suit. Dutch empirical research has examined whether LEI holders react differently from non-insured individuals when they encounter a justiciable problem.⁴⁷ Among the uninsured individuals who faced a justiciable problem, 7.5% did nothing, 47.4% sought to resolve the problem without help, and 45.1% sought advice from one or more experts or organizations. In comparison, insureds seek more advice and are less prone to resolve the problem without help: 4.8% did nothing, 37.7% sought to resolve the problem without help, and 57.5% sought

45 See e.g. E Blankenburg and J Fiedler, *Die Rechtsschutzversicherung und der steigende Geschäftsanfall der Gerichte* (Legal Insurance and the Growing Demands on the Courts) (Tübingen: Mohr, 1981); W Jagodzinski, Th Raiser and J Riehl, *Rechtsschutzversicherung und Rechtsverfolgung* (Legal Insurance and the Recourse to the Court) (1994).

46 See, e.g., R Kirstein, 'Risk Neutrality and Strategic Insurance' (2000) 25 *The Geneva Papers on Risk & Ins.* 260.

47 See BCJ van Velthoven and CM Klein Haarhuis, 'Legal Aid and Legal Expenses Insurance, Complements or Substitutes? The Case of the Netherlands' (2011) 8(3) *Journal of Empirical Legal Studies* 600-601.

advice from one or more experts or organizations. The difference between holders and non-holders of LEI particularly holds for the higher income classes. Lastly, an insured plaintiff may act tougher during settlement negotiations because he does not bear all of the costs of a trial. This decreases the settlement surplus and consequently increases the frequency of trial. However, one should not forget the active role that legal expenses insurers play in the settlement stage. In countries in which lawyers enjoy monopoly rights for representation in court but not for out-of-court work (e.g. Belgium), an insurer can reserve the right to take all necessary steps to settle the case.⁴⁸ He may have a large incentive to settle the case given that he bears most or all of the costs. This finds some support in the fact that the settlement frequency of claims covered by legal expenses insurance - 80 percent- is seemingly higher than the settlement frequency of claims not covered by LEI.⁴⁹ Note that this could also be the result of selection effects. For example, according to the relative optimism model of litigation, the settlement rate is larger for smaller claims.⁵⁰ And empirical research shows that LEI stimulates the settlement of some of these smaller claims.⁵¹ In contrast, in countries like Germany, where lawyers enjoy monopoly rights both for representation in court and for out of court work, the insurer's role in the settlement stage may be more restricted. German empirical research shows that the incidence of trial for claims covered by LEI is a bit larger than for claims not covered by LEI.⁵² Dutch research points out that court proceedings were initiated in 4% of problems for uninsured individuals compared to 6.5% of problems for insured individuals.⁵³ The difference is larger for higher income classes. As with third party financing, the presence of insurance may increase deterrence, and this in turn can have a mitigating effect on the amount of litigation. Consequently, one should always be cautious in interpreting these numbers: it is not necessarily socially undesirable if the volume of cases increases. It might be undesirable if LEI stimulates claims with a so-called nuisance value, but because access to justice is costly without insurance, too few claims may be filed, leading to under-deterrence.

4.2 The quality of litigation and the quality of settlements

48 See Ph Colle, *Handboek Bijzonder Gereguleerde Verzekeringcontracten* (Antwerp: Intersentia, 2005) 304.

49 *Id.*

50 See, e.g., S Shavell, 'Suit, Settlement, and Trial: A Theoretical Analysis under Alternative Methods for the Allocation of Legal Costs' (1982) 11 *J. Legal Stud.* 59.

51 See V Prais, 'Legal Expenses Insurance', in AAS Zuckerman and R Cranston (eds), *Reform of Civil Procedure: Essays on 'Access to Justice'* (Alderley: Clarendon Press, 1995) 439.

52 See *id.*

53 See Van Velthoven and Klein Haarhuis, *supra* note 47.

It is often claimed that LEI causes a flood of cases without merit.⁵⁴ As the argument goes, a plaintiff may be interested in filing a claim with virtually no chance of victory, solely because someone else bears the costs. However, it is doubtful that a legal expenses insurer will provide coverage for obviously weak claims. Insurers have a rather strong incentive to cautiously screen cases before providing coverage, given that they bear all or most of the costs of a trial but obtain no direct monetary benefits.⁵⁵ In practice, legal expenses insurers reject weak cases in several ways. For example, LEI policies often include a deductible.⁵⁶ Evidently, a deductible will not only weed out some weak cases, but will also inhibit some strong cases with small stakes. In addition, LEI policies often incorporate a merits test. And even if such a clause has not been included in the contract, doctrines of contract law may give insurers the right to refuse coverage for unreasonable claims, for futile claims, and for claims that lack evidence.⁵⁷ A study from Germany shows that insured litigants win their cases a little more often (3 %) than uninsured litigants who paid their attorneys a fixed fee at every stage of the litigation process.⁵⁸ While this could be a reflection of more careful case screening, this can also be explained by a selection effect (LEI encourages the filing of some strong claims with stakes that are relatively small but still outweigh the deductible).

4.3 *The timing of settlements*

Fenn et al. (2005) find evidence that claims funded by legal expenses insurance in England and Wales settle sooner than claims funded by other means.⁵⁹ The reasoning behind this is straightforward. The insurer has an incentive to settle quickly because he internalizes all or a big part of the cost of the settlement. This effect will be most pronounced if the insurer is in charge of the settlement negotiations.⁶⁰ ⁶¹ Even if an independent lawyer is in charge of the

54 See, e.g., M Kilian, 'Alternatives to Public Provision: The Rule of Legal Expenses Insurance in Broadening Access to Justice: The German Experience' (2003) 30 *J.L. & Soc'y* 45.

55 One can expect legal expense insurers to have a stronger incentive to screen cases than hourly fee lawyers or contingency fee lawyers.

56 Kilian, *supra* note 54, at 46.

57 For example, the contractually implied obligation of good faith.

58 See Prais, *supra* note 51, at 439.

59 P Fenn et al., Report to the Department for Constitutional Affairs, *The Funding of Personal Injury Litigation: Comparisons Over Time and Across Jurisdictions* 51 (2006), available at http://webarchive.nationalarchives.gov.uk/+http://www.dca.gov.uk/research/2006/02_2006.pdf.

60 In Belgium, for example, the monopoly rights of lawyers only encompass representation in court. In the context of LEI, legal services are often provided by in-house personnel.

61 Of course, an important limitation is that policyholders have the right to free choice of counsel from the moment they are involved in judicial or administrative proceedings. See art 4(1)(a) Directive 87/344/EEC on the

negotiations, the case may still be settled faster than cases that are not funded through insurance, because the insurer is most likely in a better position to control lawyer opportunism. A lawyer monitored by an insurer will be able to shirk less and will, on average, settle cases sooner.

4.4 The costs of (individual) disputes

LEI can clearly lead to an increase in the costs of individual disputes. While an uninsured plaintiff has to pay for each additional hour his lawyer spends on the case, an insured plaintiff can use the staff of the insurer, or, if necessary, a lawyer at no cost or a fraction of the true cost. Dutch empirical research corroborates this, at least for the high-income class.⁶² Once insured, the intensity of the contacts with legal advisors is significantly higher for this income class (2.09 contacts versus 1.73 contacts).⁶³ The impact of LEI is mainly by substitution for lower income classes.⁶⁴ The assistance of the staff of the insurer comes, to a large extent, in place of the subsidized lawyer.⁶⁵ Of course, other factors could have influenced the use of legal advisers.⁶⁶ After controlling for other relevant factors like the sort of problem, the complexity of the problem and expected revenue, multivariate analysis confirms their findings.⁶⁷ If a person actively responds to a justiciable problem, being insured heightens the chance that a person will ask for more legal advice.⁶⁸ Income is an important element when people are uninsured: the number of contacts with legal advisers varies in relation to income.⁶⁹ When individuals are insured, the effect of income is not significant.⁷⁰

5. A Comparison with Contingency Fees

Not only TPF and LEI exist as techniques of funding litigation and removing risk from risk-averse litigants, but also fee arrangements between clients and lawyers can, to a certain

Coordination of Laws, Regulations and Administrative Provisions relating to Legal Expenses Insurance, official reporter *OJ* 1987 L185/77, available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31987L0344:en:NOT>

⁶² See Van Velthoven and Klein Haarhuis, *supra* note 47, at 597.

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.*

⁶⁶ *Id.*, at 598.

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ *Id.*

extent, play this role. The relationship between a client and his lawyer can be analyzed as a principal-agent relationship. The lawyer may have different goals than the client, and the latter is not able to fully monitor and evaluate the behaviour of the former. This may lead to moral hazard of the lawyer (he does not exert enough effort) and/or to adverse selection (the client is not able to distinguish between high and low quality lawyers).⁷¹ In agency-relationships the contract between principal and agent may be used to (try to) better align the interests of both parties.⁷² The most studied aspect in this respect is the payment scheme of the lawyer.

Especially contingency fees ('CF') are an interesting topic in this respect. With CF, we mean a situation where if the case is lost, the lawyer receives no compensation ('no cure, no pay'). If the case is won, the fee is often a percentage of the obtained award ('*quota pars litis*'). In this section we will analyze CF from an economic perspective, focusing on the issues which are by now familiar to the reader. However, the structure of this section differs a little from the structure of Sections III and IV. This is caused by the fact that the economic insights regarding CF are made most clear when comparing CF to hourly fees ('HF'). Such a comparison warrants a slightly different structure than in the previous sections. We investigate how CF affects the volume and quality of claims (A), the settlement process (B) and the costs of individual disputes (C).

5.1 The Volume and Quality of Claims

CF are a way to finance the lawyer's costs of bringing a claim, because of the "no cure no pay" aspect. The lawyer in a sense pre-finances the case. Therefore, the plaintiff can also bring a suit in cases where the costs of HF would have prohibited him from so doing. In addition, CF shifts the financial risk regarding the attorney costs from the client to the lawyer. Lawyers can diversify their portfolio and are repeat players, so that they are likely to be less

71 The informational advantage of the lawyer over the client concerning the legal issues at stake may result in a situation where the lawyer does not always act in the best interest of the client, e.g. by providing more legal services than are actually required. See BL Hay, 'Contingent Fees and Agency Costs' (1996) 25(2) *The Journal of Legal Studies* 504 ff; BL Hay, 'Contingent Fees, Principal-Agent Problems, and the Settlement of Litigation' (1997) 23 *William Mitchell Law Review* 44 ff; DA DeMott, 'The Lawyer as Agent' (1998) 67(2) *Fordham Law Review* 301-326. L Sacconi, 'The Case against Lawyers' Contingent Fees and the Misapplication of Principal-agent Models' (2011) 32 *European Journal of Law and Economics* 263-292 on the other hand argues that agency theory is not well equipped to study the lawyer-client relationship due to bounded rationality and incomplete contracts.

72 KM Eisenhardt, 'Agency Theory: An Assessment and Review' (1989) 14 *The Academy of Management Review* 61.

risk averse than their clients. CF therefore allows a form of risk allocation that is not possible under HF, enabling risk-averse plaintiffs to also bring a claim.⁷³

These two effects may increase the volume of litigation, but only if there is over-capacity in the market for legal services. Without such over-capacity, a shift from HF to CF could even reduce the volume of litigation, if lawyers spend more time on a case under CF than under HF.⁷⁴ The choice between HF and CF is likely indeed to affect the time a lawyer spends on a case. Under HF, the lawyer is remunerated for every hour he spends on the case, so that he might be induced to spend more time than necessary. Under CF it is not attractive for the lawyer to spend more time on the case than necessary, because this does not yield additional income. On the contrary, under CF the lawyer may rather spend *too little* time on the case, because he compares the full costs of spending an additional hour with only a percentage of the expected benefits of this time investment. Empirical research suggests that CF lawyers spend more time on cases with a high value and less time on cases with a low value than HF lawyers.⁷⁵

The agreed CF percentage can also impact the volume of litigation, because it affects the expected award of the plaintiff after covering the attorney costs. Litigation entails more costs than only the lawyer's remuneration and in as far as those costs are not covered by the CF arrangement, a striking difference as compared to TPF and LEI may occur.⁷⁶ In theory, a higher CF percentage may lead to a lower volume of litigation because the expected benefits of litigation for the plaintiff decrease. On the other hand, if the higher percentage induces the lawyer to spend more effort on the case, and if this increases the probability of prevailing, the expected benefit can increase. The overall effect cannot be predicted theoretically.

73 RA Posner, *Economic Analysis of Law*, 6th edn. (New York: Aspen Publishers, 2003) 584; HSE Gravelle, 'Conditional Fees in Britain', in P Newman (ed), *The New Palgrave Dictionary of Economics and the Law* (Palgrave Macmillan, 1998) 383. This argument is less important in situations where the client is a well-informed repeat player himself.

74 LT Visscher and T Schepens, 'A Law and Economics Approach to Cost Shifting, Fee Arrangements and Legal Expense Insurance', in ML Tuil and LT Visscher (eds), *New Trends in Financing Civil Litigation in Europe: A Legal, Empirical and Economic Analysis* (Cheltenham: Edward Elgar 2010) 18.

75 This can be explained by the *quota pars litis* characteristic of contingency fees: whether or not it is worthwhile to spend more time on a case, depends on the marginal benefits of this additional time investment. For cases with a higher value, the agreed percentage yields more benefits than for cases with a lower value, inducing lawyers to spend more time on cases with a higher value. After all, in low value cases, the costs of an additional hour will relatively soon outweigh the expected benefits to the lawyer, but investing an additional hour in a high value claim is worthwhile much longer. See HM Kritzer et al., 'The Impact of Fee Arrangement on Lawyer Effort' (1985) 19 *Law & Society Review* 266-267. Also see HM Kritzer, 'Lawyer Fees and Lawyer Behaviour in Litigation: What Does the Empirical Literature Really Say?' (2002) 86 *Texas Law Review* 1968-169.

76 Of course it depends upon the specifics of the legal system to what extent this is the case. In legal systems where TPF and LEI would also cover costs other than the lawyer's remuneration (such as court fees, costs for expert witnesses etc.), those costs would then be covered under the financing arrangement while that is usually not the case under CF.

CF and HF give different incentives to lawyers to act as gatekeeper and this may affect both the volume of litigation and the quality of the claims. A client with full information about the law and about the value of the legal services provided by a lawyer could hire an HF lawyer and instruct him only to invest additional time in the case if the marginal benefits (which the fully informed client could perfectly assess) exceed the hourly fee of the lawyer.⁷⁷ In reality clients might not be fully informed and this information asymmetry may affect the behaviour of the lawyer. As mentioned above, an HF lawyer, whose remuneration does not depend on the outcome of the case, may spend more time on a case than a fully informed client would want him to. The HF lawyer may even advise to litigate, also if the expected value of the case would be lower than the costs of legal aid.⁷⁸ This problem is caused by the fact that the HF lawyer is rewarded for the number of hours spent on the case, irrespective of whether these hours yield higher benefits than costs to the client.

CF provide better incentives to the lawyer because he only receives a reward if the case is won. He will therefore be incentivized to provide better legal advice to his client regarding whether or not to start a case. Accepting or refusing a case on a CF basis therefore provides a signal to the client regarding the quality of the case, which is lacking under HF. The CF lawyer acts as a gatekeeper, because he will refuse cases with a too low probability of success. This screening effect may have a decreasing impact on the volume of litigation, because low quality claims are refused.

This characteristic of CF obviously also affects the quality of the claims. Relatively weak cases will not be litigated, because the expected reward for the lawyer is too low. The fact that the lawyer is a repeat player with better information than the client implies that the lawyer is better able to screen the cases on quality.⁷⁹ This would imply that the average quality of the cases that *are* brought, increases. This hypothesis fundamentally differs from the often-expressed fear that CF would encourage meritless litigation due to the fact that the plaintiff does not bear a financial risk when bringing a claim.

77 AM Polinsky and DL Rubinfeld, 'Aligning the Interests of Lawyers and Clients' (2003) 5 *American Law and Economics Review* 166.

78 See e.g. E Johnson Jr., 'A Theoretical Appraisal of Litigation Investment Decisions' (1980) 15 *Law & Society Review* 576 ff; PM Danzon, 'Contingent Fees for Personal Injury Litigation' (1983) 14 *The Bell Journal of Economics* 215; JD Dana and KE Spier, 'Expertise and Contingent Fees: The Role of Asymmetric Information in Attorney Compensation' (1993) 9 *The Journal of Law, Economics, & Organization* 352.

79 KM Clermont and JD Currivan, 'Improving the Contingent Fee' (1978) 63 *Cornell Law Review* 571-572; Dana and Spier, *supra* note 78, at 349, 350. Also see ThJ Miceli, 'Do Contingent Fees Promote Excessive Litigation?' (1994) 23 *The Journal of Legal Studies* 223 and A Shajnfeld, 'A Critical Survey of the Law, Ethics, and Economics of Attorney Contingent Fee Arrangements' (2010) 54 *New York Law School Law Review* 807.

Empirical research corroborates the gatekeeper-hypothesis. Based on a survey of over 500 lawyers from Wisconsin, Kritzer concludes that CF lawyers indeed act as gatekeepers. Cases with a low success probability are not accepted, because the expected reward for the lawyer is too low. Lawyers try to create a portfolio which contains enough cases yielding enough profits to compensate for lost cases. However, besides the quality of the case, the possible outcome is also relevant in this respect. High quality cases regarding a low amount are therefore also regularly refused.⁸⁰

Helland and Tabarrok measure case quality by the probability that the plaintiff terminates his case rather than continuing until a settlement or a verdict has been reached. If CF result in better screening, fewer cases should be terminated because the relatively weak cases would not have been brought in the first place. The authors compare the difference in the probability of terminating certain types of cases in States where they are tried on a CF basis with States where they are tried on an HF basis. They check their results by studying whether introducing restrictions on the use of CF in Florida in 1985 resulted in a discontinuity in the probability of terminating certain types of cases in American states.⁸¹ They conclude that restricting the use of CF results in more terminated cases, which suggests that CF indeed result in better screening of cases.⁸² This conclusion corroborates the earlier finding of Danzon and Lillard that limitations on CF result in a higher drop-out rate.⁸³

5.2 Settlements

The choice between CH and HF may have a severe impact on settlements: whether they are reached in the first place, the time it takes to reach them, and the quality thereof. On the one hand, CF lawyers may settle too quickly, because they then receive a percentage of the settlement award without much effort and without the additional costs of litigation (which the

80 Kritzer, *supra* note 24, at 26 ff. Also see HM Kritzer, *Risks, Reputations, and Rewards: Contingency Fee Legal Practice in the United States* (Stanford: Stanford University Press) 84-85.

81 E Helland and A Tabarrok, 'Contingency Fees, Settlement Delay, and Low-Quality Litigation: Empirical Evidence from Two Datasets' (2003) 19 *The Journal of Law, Economics, & Organization* 521-522.

82 *Id.*, at 529 and 533. Shajnsfeld. *supra* note 79, at 808, 809 is not convinced by these results, because the higher probability of terminating a case under HF can also be caused by a client running out of money during the adjudication process, so that he cannot afford the lawyer to spend more hours on it. Helland and Tabarrok reject this line of reasoning, because it would imply that the plaintiff, when deciding whether or not to start a claim, overlooked the fact that he would not have enough resources to be able to pay the lawyer long enough.

83 PM Danzon and LA Lillard, 'Settlement out of Court: The Disposition of Medical Malpractice Claims' (1983) 12 *The Journal of Legal Studies* 363.

lawyer would have to bear).⁸⁴ This would imply a relatively short duration before the settlement is reached, but the quality of the settlement can be low. Another theoretical reason why CF may result in settlement quicker than HF is that an HF lawyer may advise the client not to accept a settlement offer (so that the lawyer can spend more hours on the case) while the settlement would have been beneficial to the client (due to the lower legal expenses).

On the other hand there are two possible reasons why under CF settlements could be reached less quickly and less often: (1) under the assumption that the plaintiff's CF lawyer would spend too little time on the case when it is tried (because he bears the full marginal costs of the additional time invested but only gets a percentage of the marginal benefits), the *defence* lawyer may rather litigate than settle; (2) the fact that the CF lawyer receives a percentage of the final award may induce him to reject a relatively low settlement offer, in order to try to reach a higher amount in subsequent negotiations. Such an initial rejection may be perceived by the other party as a signal that the true losses of the plaintiff justify the rejection, especially under CF, because otherwise the lawyer would have accepted the offer. Rickman labels this behaviour 'hard bargaining'.⁸⁵

Thus theoretical literature does not yield unambiguous predictions regarding the impact of CF on settlements. Danzon and Lillard have empirically investigated the way in which about 6,000 American cases of medical malpractice have been resolved.⁸⁶ They analyze, among many others factors, the impact of restrictions on the use of CF (such as establishing a maximum percentage). They conclude that such restrictions result in more settlements and in lower settlement awards.⁸⁷

Snyder and Hughes reach a similar conclusion in their empirical research regarding the influence of several legislative changes regarding the way in which medical malpractice claims are handled in Florida: restrictions on the use of CF results in more settlements.⁸⁸ Helland and Tabarrok investigate the impact of restrictions on CF on the time it takes to reach a settlement and they find that such restrictions result in a longer duration.⁸⁹ This, together

84 See e.g. H Gravelle and M Waterson, 'No Win, No Fee: Some Economics of Contingent Legal Fees' (1993) 103 *The Economic Journal* 1215. The authors in their model can vary the extent in which the lawyer is driven by his own interests vis-à-vis the interests of the client. If a lawyer puts more emphasis on the client's interests than on his own interests (the authors label such a lawyer as 'relatively altruistic'), the effect that the lawyer settles too quickly does not appear. Also see Shajnfeld, *supra* note 79, at 792 ff.

85 N Rickman, 'Contingent Fees and Litigation Settlement' (1999) 19 *International Review of Law and Economics* 306.

86 Danzon and Lillard, *supra* note 83, at 348.

87 *Id.*, at 363-366.

88 EA Snyder and JW Hughes, 'The English Rule for Allocating Legal Costs: Evidence Confronts Theory' (1990) 6 *The Journal of Law, Economics, & Organization* 366.

89 Helland and Tabarrok, *supra* note 81, at 536, 538.

with the results of Kritzer et al. and Danzon and Lillard, suggests that HF lawyers have more incentives to delay the settlement process,⁹⁰ but also that CF result in fewer settlements because the expected costs of the defendant decrease, and because the plaintiff's lawyer chooses 'hard bargaining'. Therefore, the line of reasoning that CF lawyers settle easily in order to receive a percentage of the award without much effort, has to be rejected. On the contrary, under CF there is a larger probability that a claim proceeds to trial than under HF. But *if* a settlement is reached under CF, it generally takes less time to reach it than under HF.

5.3 *The costs of disputes*

Above it was established that under CF there is a larger probability that a claim proceeds to trial than under HF. Given the fact that settlements are less costly than trials, this tendency may increase the costs of disputes. On the other hand, the duration of claims (during settlement but also during trial) is shorter under CF than under HF, because a CF lawyer does not gain by delaying the procedure while the HF lawyer does.⁹¹ The better screening under CF in addition prevents low quality claims from being tried, which also reduces the costs of disputes. It cannot be predicted theoretically which of the above-mentioned effects dominates.

However, because CF enables claims to be brought that could not be brought under HF, the volume of litigation is expected to increase, so that the costs of dispute rise. After all, such claims would not have been brought under HF and hence would not have resulted in litigation costs.

The ultimate empirical question, which brings us back to the economic *raison d'être* of CF, LEI and TPF, of course is whether the increased litigation costs are outweighed by the desirable effects of the behavioural incentives which result from the fact that the negative externality is now internalized. In that case, enough *potential* claims are avoided to make the increased litigation costs for those cases that are not avoided, worthwhile. The total effect then would be that ultimately fewer cases are tried because fewer violations occur.⁹² This issue, however, lies beyond the scope of our contribution.

90 *Id.*, at 540.

91 Not to mention the possibility that an HF lawyer bills more hours than he has actually spent on the case. See e.g. LG Lerman, 'Lying to Clients' (1990) 130 *University of Pennsylvania Law Review* 705, 706.

92 See ThJ Miceli and K Segerson, 'Contingent Fees for Lawyers: The Impact on Litigation and Accident Prevention' (1991) 20 *Journal of Legal Studies* 381-399; AW Katz, 'Indemnity of Legal Fees', in B Boukaert and G De Geest (eds), *Encyclopedia of Law and Economics, Vol. 5, The Economics of Crime and Litigation* (Cheltenham: Edward Elgar, 2000) 76.

6. Concluding Remarks

In this chapter we aimed at providing an economic perspective on TPF. Our goal was to answer the question why TPF emerges and what could be its economic function, especially in the light of alternative financing mechanisms such as legal expenses insurance (LEI) and contingency fees (CF). Of course, the goal of this chapter was not to dwell on the many different ways in which TPF can appear. We mainly looked at mechanisms whereby a third party finances litigation on a “no cure no pay” basis, whereby the remuneration for the funder will usually consist of a percentage of the proceeds of the case. However, one could well imagine (and also observe in practice) other forms of TPF, for example where a TPF funder provides a loan to a law firm. Also the institutions providing funds can differ. Theoretically, the law firms could also provide TPF (although in that case the difference with CF of course becomes very small). Instead of focusing on those different appearances of TPF, we have rather focused on the question why it is that TPF has emerged. From an economic perspective we find a relatively straight-forward explanation in the fact that for several reasons, meritorious lawsuits are not brought. High risk aversion against costs may be a problem, but also the mere fact of lacking possibilities for pre-financing a claim. From an economic perspective, the fact that those meritorious claims are not brought is problematic, for the simple reason that tortfeasors causing externalities are not sufficiently confronted with the social costs of their activities. This is a market failure. To the extent that TPF can contribute to lowering the barriers to access to justice it can be considered as socially beneficial as it contributes to solving the market failure. Notwithstanding those beneficial aspects of TPF, we have noticed that there are quite a few legal systems that are opposed to TPF. In some legal systems TPF does not emerge (even though there are no legal objections), in others there is an outright prohibition. Although all systems where a third party finances litigation could give rise to adverse selection (an undesirable increase in the volume of litigation where suits lacking merit would also be brought), moral hazard (as a result of which the plaintiff would no longer have adequate incentives for risk reduction during litigation) or free riding (whereby others who do not finance the claim could benefit as well), adequate remedies have been indicated in the literature and are also possible to implement in practice.

The remainder of our contribution focused on the comparative benefits of TPF, especially in the context of the alternatives CF and LEI. We have compared TPF, LEI and CF on the

basis of their influence on the volume of litigation, timing, quality, settlements, and total costs. As is often the case with these types of comparison, the devil is in the detail. Hence it is impossible to generally argue that one financing system would be preferred to the other as the type of influence of any specific mechanism is highly dependent on the type of cases and the particular design mechanism chosen. In fact, in all three mechanisms (TPF, LEI and CF) there is a third party that finances a claim and so that will exercise some gate-keeping function to ensure that only meritorious suits are brought. One important difference between on the one hand CF and on the other hand LEI and TPF is that CF only seems to cover the remuneration of the lawyer, whereas LEI and TPF could also cover other costs. If that indeed is the case, LEI and TPF are relatively attractive for the litigant and could therefore better contribute to a lowering of the barriers to access to justice.

Of course there are important differences as far as the influence of the particular funder on the course of the procedure and on the decision to settle are concerned. With CF that influence may be the largest since the funder is the lawyer himself who decides on the strategy during trial and also on the content and timing of the settlement. Both under LEI and CF, the funder (insurer or lawyer) will have considerable (but not perfect) incentives to optimize the litigation strategy in the interest of the client and also to avoid very long lasting trials. Under LEI that would only increase the costs of the insurer (especially if the lawyer paid under LEI is compensated on the basis of an hourly fee). Also under CF, lawyers cannot benefit from investing more in a trial than would be reasonable. It is only under TPF that the question arises of to what extent funders have sufficient expertise and information in order to allow them to adequately monitor the procedure and hence the settlement process. If their intervention is limited to the ex ante financing and if no further monitoring takes place, TPF could create the danger of an over-long trial.

TPF, LEI and CF are all attractive mechanisms which can lower the barriers to access to justice and hence remedy the market failure caused by the fact that meritorious suits are not always brought. In that sense there is no particular reason to prefer one over the other. The reason why these different types of financing mechanisms emerge often has to do with the fact that for one reason or another not all systems may be available. For example, as far as LEI is concerned, we have already indicated that in systems where LEI is voluntary, the number of persons concluding LEI is relatively low. The fact that LEI may create positive externalities could reduce the incentives to purchase LEI. With CF the problem is that many legal systems in Continental Europe have (in different forms) prohibitions on it. In those legal systems where CF is prohibited and individuals do not conclude a LEI before the event, TPF

may often be the only financing remedy available to plaintiffs. If on the other hand LEI were to be widely used in a particular legal system and/or the system also allowed CF, the demand for TPF may be reduced or TPF would then focus on those cases where (for a variety of reasons) CF is not available.

From a law and economics perspective the fact that many different financing mechanisms are available on the market only seems positive and beneficial. The competition between those different mechanisms can also allow an increase of quality and a diversified supply of financing mechanisms to litigants. As such there is little reason to argue in favour of any particular form of regulation, other than that the information on the specificities and contents of the various financing mechanisms is presented in a clear and transparent manner, allowing litigants an informed choice. On the contrary, much of the regulation that has intervened in this domain so far, e.g. prohibiting particular kinds of TPF, LEI or CF in particular legal systems, can only be classified as inefficient. Those types of regulation often come into being in order to benefit particular interest groups but in fact only increase the barriers to access to justice rather than lowering them. Although this should undoubtedly still be subject to further research, at this stage we argue that regulation in this domain seems to have done more harm than anything else. A facilitative type of regulation stimulating the emergence of differing financing mechanisms in a competitive environment seems a better way to simulate access to justice and hence to remedy market failures.

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