



New Trends in Financing Civil Litigation in Europe.....

A Legal, Empirical,
and Economic Analysis

Edited by
MARK TUIL
and LOUIS VISSCHER



New Horizons in Law and Economics

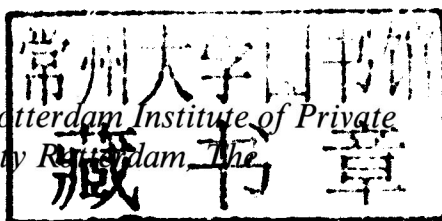
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NEW HORIZONS IN LAW AND ECONOMICS

Edward Elgar

Cheltenham, UK • Northampton, MA, USA

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Published by
Edward Elgar Publishing Limited
The Lypiatts
15 Lansdown Road
Cheltenham
Glos GL50 2JA
UK

Edward Elgar Publishing, Inc.
William Pratt House
9 Dewey Court
Northampton
Massachusetts 01060
USA

A catalogue record for this book
is available from the British Library

Library of Congress Control Number: 2010927658



ISBN 978 1 84844 685 4

Typeset by Servis Filmsetting Ltd, Stockport, Cheshire
Printed and bound by MPG Books Group, UK

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NEW HORIZONS IN LAW AND ECONOMICS

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Acknowledgements

This project, both the conference held in Rotterdam in April 2009 and the current volume, would not have been possible without the contribution of many people. We explicitly would like to thank the Erasmus Trustfonds and the research programme 'Behavioural Approaches to Contract and Tort' for their financial support for the organization of the conference, and the people working at Edward Elgar for their assistance in the publication of this book.

Tables

3.1	Results of quick scan	50
4.1	Fee agreements, fee allocation and probability of success	80
7.1	Number of closed, commenced and outstanding conditional fee, hourly fee and legal aid cases in 109 firms between July 1999 and June 2000	138

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Contents

<i>Acknowledgements</i>	vi
<i>List of tables</i>	vii
<i>List of contributors</i>	viii
1. Introduction	1
<i>Mark Tuil and Louis Visscher</i>	
2. A law and economics approach to cost shifting, fee arrangements and legal expense insurance	7
<i>Louis Visscher and Tom Schepens</i>	
3. No cure, no pay and contingency fees	33
<i>Michael Faure, Fokke Fernhout and Niels Philipsen</i>	
4. Financing and group litigation	57
<i>Sonja Keske, Andrea Renda and Roger Van den Bergh</i>	
5. Financing civil litigation by the European insurance industry	92
<i>Willem H. van Boom</i>	
6. Financing civil litigation: the case for the assignment and securitization of liability claims	109
<i>Andrea Pinna</i>	
7. The empirical analysis of litigation funding	131
<i>Paul Fenn and Neil Rickman</i>	
8. Financing civil litigation: the US perspective	149
<i>Deborah R. Hensler</i>	
9. New trends in financing civil litigation in Europe: lessons to be learned	175
<i>Mark Tuil and Louis Visscher</i>	
<i>Index</i>	191

1. Introduction

Mark Tuil and Louis Visscher

1. THE PROBLEM OF FINANCING CIVIL LITIGATION

Due to several factors not every meritorious claim is brought to justice. One of these factors is the costs that need to be incurred, which might be too high to make the claim feasible in practice. Such barriers to the effectuation of a claim are problematic for the following reasons: firstly, they effectively frustrate access to justice; secondly, civil litigation is the driving force behind private enforcement; and thirdly, the behavioural incentives that actors may derive from the legal rules are reduced by the financing problem. Traditionally this funding problem is overcome in part by government-subsidized legal aid. However, the budget available for legal aid in most European countries and indeed worldwide is limited and is under threat of reduction.

Many techniques other than government subsidized legal aid may also overcome the aforementioned problem. Parties can buy legal expense insurance, both 'before-the-event' and 'after-the-event'. Result-based fees for lawyers such as contingency fees and conditional fee arrangements enable plaintiffs to initiate a claim without bearing a financial risk. Collectivization of claims into class actions, collective actions, and/or representative actions might substantially decrease the costs per plaintiff. Cost shifting arrangements exist, such as the English Rule or the inclusion of extra-judicial costs in the determination of damages. Finally, several 'market solutions' can be distinguished, such as the Cartel Damage Claims (CDC) whereby victims of antitrust law infringements can sell their claim to CDC for a fixed price plus an additional percentage of the realized damage claims. The auctioning of claims can also be regarded as a possible market solution.

With the decrease in government budgets for legal aid, the importance of these techniques has increased and they have been gradually introduced to a more or lesser extent into the various European legal systems. The introduction of these solutions to the funding problem into the European

legal systems poses a number of interesting questions. The first question is, of course, whether these solutions actually provide access to justice in cases where such access would have been lacking under the conventional system. From a legal point of view the most important question is whether these solutions are allowed. Here it is also important to ask whether such solutions *should* be allowed. In this respect it is important to assess whether these solutions do not create problems in their own right. For example, in many European jurisdictions the introduction of result-based fees for lawyers is regarded as problematic, as this could provide the lawyer with incentives not to act in the best interests of his client. For this reason the European Bar Association (CBBE) for example forbids the *pactum de quata litis* in paragraph 3.3 of their code of conduct. Moreover, the fear is often voiced that introducing result-based fees will have harmful effects on society as a whole, because it would lead to a 'claim culture', that is a culture where disputes are overlitigated. Both with respect to harmful effects for the individual litigants and the effect for society as a whole, reference is often made to the US situation.

These kinds of questions cannot be adequately answered from any single perspective. This book aims at analyzing different possible solutions to the financing problems from a legal, empirical, and law and economics point of view. The legal analysis focuses on the question of which financing techniques are legally available and how they are embedded in the existing legal frameworks. The empirical analysis investigates to what extent the theoretically available instruments are actually applied in practice and what effects these instruments have on the behaviour of parties. The law and economics analysis focuses on the strengths and weaknesses of the distinguished instruments from the point of view of maximizing social welfare.

2. METHODOLOGY

As has been explained above, in this book multiple methods are used to address the questions raised by the (prospective) introduction of new solutions to increase access to justice. The approach taken as a whole may therefore be classified as multidisciplinary. This does not mean to say that every author in this book employs a multidisciplinary approach, rather it is arrived at by combining the different approaches taken by the contributors. Three main approaches may be distinguished.

- The legal approach is employed to address the question of what solutions are allowed to the funding problem and what principles

underlie allowing or prohibiting a certain instrument. As mentioned above, many European jurisdictions prohibit certain result-based fee arrangements for lawyers. A legal approach may be used to describe to what extent result-based fees for lawyers are allowed within a certain legal system and what principles are served by the prohibition of a certain result-based fee arrangement.

- The law and economics approach analyses the behaviour of parties from the point of view of maximizing social welfare. Applied to the topic of financing civil litigation, it analyses the reasons why rational people may not start a claim (for example, because they assess that the costs of the claim are higher than the expected outcome), as well as the way in which the various instruments affect the whole dispute resolution process.
- The empirical approach is a necessary addition to both the legal and the law and economics perspective, because these disciplines are in the end concerned with the actual behaviour of parties. The predictions that law and economics makes on the basis of a model should be tested against empirical data and, if necessary, the model needs to be changed or refined. For example, the predictions of law and economics are often based on certain assumptions or estimates about the relative size of certain, often countervailing, effects. An empirical approach may provide greater insight into the size of these effects, thereby offering the possibility of increasing the accuracy of the predictions.

Similarly, a legal rule is not a purpose in and of itself. It exists to control or facilitate the behaviour of parties. If it is shown that the behaviour the rule is meant to control is absent or that the rule creates problems of its own, the rule may be changed. An empirical approach is therefore a necessary addition to both law and economics as legal scholarship.

3. FRAMEWORK OF THE RESEARCH

This book is the result of the conference ‘New Trends in Financing Civil Litigation in Europe’ held on April 24, 2009. This conference was organized as part of the research programme ‘Behavioural Approaches to Contract and Tort: Relevancy for Policymakers’ of the Erasmus School of Law at the Erasmus University Rotterdam. This programme strives to incorporate insights from the behavioural sciences such as Economics, Psychology and Sociology into the study of Contract and Tort Law.

4. STRUCTURE OF THE BOOK

As was described above, many different solutions exist to the litigation funding problem, all of which are studied in detail by the contributors to this book. Before this detailed analysis, Visscher and Schepens start with a general introduction into these solutions from a law and economics point of view. They begin by introducing the law and economics perspective on legal rules in their capacity of providing actors with behavioural incentives by allocating costs which arise out of different activities. However, if the costs of starting litigation to effectuate these rules are too high, the rules will not be effectuated because the person who should start a claim remains rationally apathetic. The effect is that the behavioural incentives, which the law intends to provide, do not reach the party they are aimed at.

Visscher and Schepens analyse three possible ways of overcoming this rational apathy problem: cost shifting, fee arrangements and legal expenses insurance. All of these approaches shift (some of) the costs of civil litigation to a party other than the plaintiff. Cost shifting entails that (part of) the litigation costs of a successful plaintiff are transferred to the defendant. Fee arrangements lead to the result that the plaintiff only bears attorney costs if he wins. Legal expense insurance shifts the costs to the insurer, in exchange for a premium. By lowering the financial hurdles of bringing a claim, all instruments may provide solutions to the problem of financing civil litigation, thereby improving the behavioural incentives that the legal system can provide.

Visscher and Schepens analyse the possible impact of cost shifting, fee arrangements and legal expenses insurance not only on the number of suits being brought, but on all stages in the dispute resolution process: (1) filing a claim, (2) possibly dropping the claim due to new information, (3) settlement negotiations and (4) adjudication. They investigate the impact of the various instruments by comparing them with the situation where the plaintiff himself bears the costs.

Faure, Fernhout and Philipsen explore the role of result-based fees for lawyers. They note that in Europe these fee arrangements are very controversial. They outline the debate by listing the arguments in favour and against result-based fees for lawyers. They then give strict definitions of different types of result-based fees and go deeper into the law and economics theory behind these fee schemes. They give a comparative overview of the possibilities to agree to result-based fees in Belgium, Denmark, England and Wales, France, Germany, Greece, Ireland, Hong Kong and the Netherlands.

Keske, Van den Bergh and Renda analyse the role of the collectivization of claims as a means to alleviate the funding problem. They first describe

the advantages and disadvantages of collective actions. In Europe there is much resistance against the American style class action. Instead, the European commission promotes the 'European model' of the representative actions by consumer associations. Keske, Van den Bergh and Renda analyse the advantages and disadvantages of this model compared to the American model, as well as the role of fee arrangements and private and public funding on collective actions.

Van Boom addresses the role of Legal Expenses Insurance (LEI) as an option to solve the funding problem. He analyses both Before-The-Event Insurance (BTE) and After-The-Event Insurance (ATE). In doing so, Van Boom describes the market for BTE and its legal context, the LEI directive. This directive stipulates the free choice of counsel for legal expense insurance policy holders. Van Boom describes how legal expense insurers strive to keep the costs of legal services down and how the free choice of counsel conflicts with this goal of keeping costs down. When discussing ATE, Van Boom distinguishes between ATE as a form of third-party funding and ATE as an add-on to an English style conditional fee arrangement.

Pinna addresses the possibility of dealing with the funding problem by way of the assignment of a liability claim to an investor, who would 'acquire' the claim and bring a claim in compensation in its own name and on his own behalf. Pinna argues that this model would in principle be a sound solution. He then examines the legality of the assignment of a liability claim under English and French law. Pinna takes position in favour of the assignment of liability claims, especially as a solution to the absence of other techniques, such as mandatory damage insurance, compensation schemes or class actions, which already aim at finding an alternative to the traditional way of seeking compensation for an injured party by an individual claim in court. He also notes that the option of assignment has the added benefit that the liability claim may be securitized.

Fenn and Rickman survey recent research on the empirical analysis of the effects of litigation finance. Drawn in particular from econometric studies of England and Wales and the US, it touches upon contingency fees, hourly fees, legal aid, conditional fees and legal expenses insurance. Fenn and Rickman present a theoretical model to demonstrate the kinds of factors that litigation finance may be expected to influence, in particular case screening, case outcome (including any settlement amount), settlement timing, the volume of litigation, and potential conflicts between lawyer and client. They find that finance plays a statistically significant role in litigation and, for this reason alone, should be taken seriously by policy makers.

As was noted before, much of the debate on financing litigation is conducted against the background of 'the American experience'. However, to

what extent the statements about this experience are accurate, or the fear of 'American situations' is justified, remains unclear. Hensler addresses the American system of financing, both non-mass and mass litigation (the latter both via class actions as otherwise) and the role of contingency fees in this respect. She also tackles the difficult question of whether the US legal financing rules lead to excessive litigation.

2. A law and economics approach to cost shifting, fee arrangements and legal expense insurance

Louis Visscher and Tom Schepens

1. INTRODUCTION

In this chapter, we will provide an overview of the economic literature regarding cost shifting, fee arrangements and legal expense insurance. In the economic analysis of law, legal rules are regarded as instruments which can provide actors with behavioural incentives. In essence, private law (torts, contracts, property, etc.) allocates the costs which arise out of different activities. Those costs may only be borne by the party causing them if the party initially suffering from them brings suit. Problems in financing civil litigation may effectively hinder such lawsuits, so that the behavioural incentives which the law intends to provide do not reach the party causing the harm.

For example, tort law is regarded as an instrument that induces people to take care. The prospect of being held liable after negligently having caused losses may induce a potential tortfeasor to take due care, because taking due care (thereby avoiding liability) is less costly than taking too little care (and being liable). Contract law is seen as a device that enables people to increase welfare by engaging in voluntary transactions. The remedies of contract law (specific performance and damages) induce the debtor to fulfil his contractual duties when this is less costly than breaching the contract and facing the sanction. If the victim of a tort or the creditor in a contractual setting does not bring a claim against the tortfeasor or the debtor, neither the tortfeasor nor debtor would face any expected sanction. This would not confront them with the costs they have caused and hence they would not receive the desired incentives. After all, in deciding how to behave, rational actors do not look at the costs they may cause, but only at the costs they may have to bear (Schäfer 2000, p. 184).

Many reasons exist that explain why actors such as the victim of a tort or the creditor in a contract may not effectuate their claim. The first