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“Third Party Contingency” contracts in settlement and litigation.[†]

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Abstract

We present, for the first time, a model of recent institutional developments in litigation funding across several European jurisdictions. Recognizing the financing constraints that British cost rules may impose on litigants, these new contractual arrangements combine contingency fees with third party cover for cost in the event of losing the case: we call these “Third Party Contingency” (TPC) contracts. We find that signing a TPC contract can make filing a suit credible and increases settlement amounts. This does not, however, increase the likelihood of going to trial, since TPC contracts are only of mutual benefit to the plaintiff and the third party when the case settles out of court. We also find that the *mere availability* of TPCs may generate the above strategic effect.

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1 Introduction

This paper analyzes a new contractual arrangement that has arisen in Central Europe recently and which is mirrored by developments in other European jurisdictions. A party that is not involved in the legal dispute, like an insurance firm, proposes a prospective plaintiff to cover his litigation cost if the case is decided in trial and demands, in turn, a share of the settlement or trial proceeds. We call this a “Third Party Contingency” (or TPC) contract to distinguish it from contingent fee arrangements between a plaintiff and his lawyer.

Legal cost and its funding can play a pivotal role in assuring access to justice and efficiency of the civil legal system. The principal issues at stake are the magnitude and unpredictability of the cost of running a legal case and the timing of this expenditure.¹ Thus, fighting a case can be expensive, and much of the expenditure may occur before an award of damages that can be used to fund it. Furthermore, in some jurisdictions the rules of civil procedure require the loser (whose identity cannot be known in advance) to pay the winner’s cost - the so-called “British” cost rule. Even under this cost-shifting rule individuals who are risk averse or liquidity constrained may be prevented from bringing a case, thus preventing the legal system from achieving its twin goals of compensation and efficient deterrence.

In such circumstances, it is unsurprising - and desirable - that institutional mechanisms develop to provide liquidity and insurance to prospective litigants. Broadly, several sources of such funds can be distinguished. In the US, lawyers typically bear a measure of risk and front-loading of cost by taking cases on a contingency fee basis and meeting upfront disbursements. In some European jurisdictions, insurance companies perform similar functions by offering before-the-event Legal Cost Insurance policies that have to be purchased before any actionable event. Elsewhere in Europe (e.g. the UK and Holland) state-sponsored legal aid has, until recently, provided tax-financed assistance to litigants whose financial status satisfied a means test and whose cases were judged to be of sufficient merit.

Importantly, recent experience suggests that the menu of funding arrangements can be extremely dynamic in response to changing circumstances with third parties being involved in many of these developments. In England and Wales, for example, the growing cost of legal aid in the 1980s and early 1990s

¹BEBCHUK (1998) correctly points out that cases of negative expected value (the expected litigation cost exceed the expected returns from the judgement) do not necessarily are unjustified. Even a legitimate claim can face a cost barrier that is too high.

led the government to withdraw it (in 1999) from many types of case and to promote other (private) means of funding. In particular, conditional fee agreements (where the lawyer waives his hourly fee in the event of loss, in return for a predetermined percentage uplift in the event of success) have moved to the fore along with after-the-event insurance policies, purchased *after* an actionable event from legal cost insurers. The combined effect of these arrangements is to insulate the litigant from own and opposing legal fees in the event of a loss. More broadly, a variety of new insurance products are appearing in a market where Legal Cost Insurance has traditionally been stifled by legal aid.²

Other jurisdictions are seeing similar interesting, and economically important, developments. Thus, an increasing number of German firms have begun to offer “Third Party Contingency” contract, thereby introducing US-style contingency arrangements under the British cost allocation rule.³ In line with UK developments, a TPC contract can be closed after-the-event. The third party agrees to cover the potential plaintiff’s cost in the event of a loss (under the British rule, this will include the opponent’s cost). In turn, the third party does not receive an up-front payment (as in the case of a Legal Cost Insurance),⁴ but demands a pre-specified fraction of any damages if the case is successful.

By helping to diversify the risks of paying all cost in the event of loss, insurers help meet a traditional objection to the use of contingency payment under a British cost rule: contingency fees do not - in principle - protect the plaintiff against own disbursement or the opponent’s in the event of a loss.⁵ A Legal Cost Insurance, on the other hand, would cover both sides’ attorney cost as well as the court fees. Only larger legal firms would be able to offer contingent fee contracts containing such protection. If smaller law firms would not be able to cover this risk, then their clients were burdened with it, and the objectives of the contingency funding would be blunted. Bearing this in mind, it is important to consider how these new institutional developments may influence the performance of the legal system.

²See RICKMAN/GRAY (1995); FENN/GRAY/RICKMAN/CARRIER (2002).

³FORIS AG (see www.foris-ag.de) was the first to introduce such arrangements. Within the last few years, numerous competitors in Germany, Switzerland, and Austria have emerged, among which are www.juragent-derprozessfinanzierer.de, www.prozessfinanzierung.at, www.das-profi.de, www.gloria-prozessfinanzierung.de and www.exactor.de.

⁴See BEBCHUK (1996) for a general discussion of the strategic effect of up-front payments that decrease the remaining trial cost and thereby make the threat to sue credible; see KIRSTEIN (2000) for an application to the case of Legal Cost Insurance.

⁵LORD CHANCELLOR’S DEPARTMENT (1989).

The purpose of this paper is to analyze the particular class of such new arrangements, exemplified by the TPC contracts described above. We pay particular attention to the incentives they create for bringing cases and for settling or trying them. We focus on these because some of the other developments mentioned above have received treatment elsewhere.⁶ Our work builds on existing treatments of the economics of litigation, cost rules and fee arrangements. From POSNER (1973) through BEBCHUK (1984), REINGANUM/WILDE (1986) to SPIER (1992), economic influences of procedural arrangements (such as cost rules) on legal cases have been considered. Similarly, a variety of authors have analysed the effects of fee arrangements in this area.⁷ Most recently, models have started to look at the role played by Legal Cost Insurance.⁸ In a paper related to ours, Smith (1992) considers the combination of British cost rules with US-style contingency fees. However, his paper bears incomplete resemblance to the institutional characteristics of mechanisms now emerging to make this link (such as the role of third parties) and his framework ignores many strategic issues. By providing a treatment of the institutional details and some of the strategic issues, our paper is therefore the first game-theoretic model of the latest class of funding arrangements, the TPC contracts.

The paper proceeds as follows. In the next section, we present a model of the decision to settle/drop or try a legal case. The model is based on the “divergent expectations approach”.⁹ It examines the conditions under which a “bargaining range” exists within which the litigants can negotiate a settlement of the case (given their expectations about what will happen if negotiations fail).¹⁰ We then compute and compare the subgame perfect equilibria for three versions of the settlement game: a benchmark case without TPCs; a case where such arrangements are in place at the start of settlement negotiations; and a case where they can be entered into even after the

⁶E.g., EMONS (2000) on contingent fees, or GRAVELLE/WATERSON (1993), who analyzed UK conditional fees.

⁷See RICKMAN (1994) and (1999) for a survey.

⁸See KIRSTEIN (2000), van VELTHOEVEN/van WIJCK (2001) and HEYES/RICKMAN/TZAVARA (2001).

⁹See POSNER (1973), SHAVELL (1982). The paper by PRIEST/KLEIN (1984) started an ongoing debate concerning the “trial-selection-hypothesis”.

¹⁰The divergent expectations approach has an attractive simplicity given that we are providing an analysis of a new funding mechanism. An alternative approach would model the settlement process as the outcome of a bargaining game with asymmetric information (e.g. BEBCHUK, 1984; REINGANUM/WILDE, 1986) that may take place over time (e.g. SPIER, 1992). An ongoing empirical debate surrounds which of these approaches is generally most appropriate; WALDFOGEL (1998) presents evidence that Posner-type models such as ours have more empirical relevance than asymmetric information models.

settlement negotiations have already started. The fourth section contains a discussion of possible modifications of the model, and the final section offers our conclusions.

2 “Third Party Contingency” contracts

2.1 The basic model

Suppose, following an accident, that a plaintiff (P) has a claim against a defendant (D). In order to fund his claim, P may either retain a lawyer on a standard (hourly) contract or enter into a TPC contract with an insurer (denoted F).¹¹ Our objective is to analyse the circumstances in which such a contract will be offered and purchased, and its effects on the ensuing litigation.

The value of P’s claim is $Y > 0$ and aggregate litigation cost (of P and D) are $G > 0$ if a trial occurs, whereas settlement cost are zero for simplicity. We assume the British cost allocation rule: the loser has to pay both parties’ cost. Both P and D have subjective beliefs that P will win at trial.¹² We denote the subjective probability beliefs of litigant $i \in \{P; D\}$ as q_i , with $0 < q_i < 1$. Finally, P, D and F are all assumed to be risk neutral.

Our basic model consists of three stages:

1. P and F may bargain over a TPC contract. If they make a contract then F commits to covering the litigation cost if P loses at trial.¹³ In turn, F receives a share $\mu \in]0, 1[$ of all returns P acquires. Without a contract, F receives nothing and P has to bear the full litigation cost in case he loses in court.
2. In both cases, with and without a TPC contract, the parties of the dispute, P and D, negotiate over a settlement. If they come to an

¹¹In principle, D may also enter into a contingency-style contract to fund the defence: see PAINTER (1995) for a discussion of this possibility.

¹²F and P are assumed to have identical beliefs as to the plaintiff’s chances of prevailing in court. This assumption does not reflect the expertise F may have in evaluating a case, though it is possible that P’s attorney may have provided similar advice. However, this simplification helps to keep the model tractable.

¹³As we have noted, this assumption distinguishes the present contracts from the way that contingency fees have traditionally been envisaged in the context of British cost rules. We note that a veto clause can sometimes relax F’s exposure to cost but incorporating this would be beyond the scope of the current paper.

agreement then the payoffs are $[S, -S, 0]$ without a TPC contract, and $[(1 - \mu)S_F, -S_F, \mu S_F]$ if a TPC contract has been made. To keep the analysis simple, we assume the symmetric Nash bargaining solution (with equal bargaining power) when solving for the settlement amount.¹⁴

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

The basic model rests on the assumption that no settlement negotiations between P and D take place before F and P have bargained about a TPC contract. In the following sections, we analyze the subgame perfect equilibria of this litigation game. Section 2.2 presents an analysis of the subgame in which no TPC contract has been closed (this subgame is called “Game 1” and would be equivalent to a situation where TPC contracts are not available at all). In section 2.3, we complete the analysis of the basic model (which we call “Game 2”): first, we derive the subgame results when a TPC contract has been signed; then we compare these results with those of Game 1.

In a modification of the basic model, we allow for settlement negotiations between P and D to take place before F and P have talked about a contract. This is called “Game 3” and will be analyzed in section 3.1. The modification demonstrates the strategic impact of the availability of TPC contracts, even if they are not used in equilibrium.

2.2 No TPC contract: Game 1

Figure 1 shows the sequence of events in Game 1, the situation without a TPC contract. Here, P and D bargain over the case without P having any recourse to F. The first event is the settlement bargaining between P and D, represented by the rectangle in Figure 1 that is labeled with (P, D). If the parties come to an agreement, the payoffs of P, D and F (who is not involved yet) are $[S, -S, 0]$. The other payoffs can easily be derived, using the trial

¹⁴Our results would also hold for an asymmetric bargaining situation, as long as the bargaining power is not entirely in the plaintiff’s hands. In that case his position cannot be improved anymore by a strategic move. The Nash bargaining solution can be shown to approximate a number of well-known strategic bargaining extensive forms, so its use does not preclude some examples of non-cooperative behaviour: see BINMORE/RUBINSTEIN/WOLINSKY (1986).

technology: if P proceeds to trial, he expects to prevail with probability q_P , which would yield Y . He expects to lose with probability $(1 - q_P)$, having to bear litigation cost G . D expects to lose with probability q_D ; in this case he has to pay $Y + G$, and zero otherwise. If P does not proceed to court, all players get zero payoff.

Figure 1: Event tree of Game 1

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

$$q_P > \frac{G}{Y + G} \quad (1)$$

If, on the one hand, condition (1) is fulfilled, then the parties will meet in court if no settlement occurs. In this case, D faces an expected loss of $-q_D(Y + G)$ if he fails to settle. A settlement payment S is hence acceptable for him if it is smaller than the absolute expected loss at trial, or if $S < q_D(Y + G)$. P's expected payoff from trial is $q_P Y - (1 - q_P)G$. Thus, P accepts a settlement that exceeds this expected payment, i.e., if $S > q_P Y - (1 - q_P)G$. Therefore, the bargaining range in a PEV case without TPC contract is

$$]q_P Y - (1 - q_P)G, q_D(Y + G)[\quad (2)$$

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

$q_D(Y + G)$ or, equivalently,

$$q_P > q_D + \frac{G}{Y + G} \quad (3)$$

If, however, $q_P Y - (1 - q_P)G < q_D(Y + G)$ holds, then the bargaining range is non-empty and the parties agree upon a settlement. Applying the symmetric Nash bargaining solution, the predicted bargaining result is $\hat{S} = 0.5[q_P Y - (1 - q_P)G] + 0.5q_D(Y + G)$ or, equivalently,

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

If, on the other hand, condition (1) is violated, or $q_P Y < (1 - q_P)G$, then the case has negative expected value (NEV).¹⁵ If no settlement occurs, then P will not proceed to court, and both parties' payoffs are zero. Thus, in a NEV case the bargaining range is $]0, 0[$ which is an empty set. In this situation, P's threat to sue is not credible.

The above analysis demonstrates that Game 1 will always have a unique subgame perfect equilibrium. Three outcomes are possible; it depends on the parameters Y, G, q_P and q_D which is the true one. This leads to our first result.

Proposition 1: In the subgame without TPC contract (Game 1), given Y, G, q_P and q_D ,

- P refuses to settle and proceeds to court if, and only if,
 $q_P > q_D + G/(Y + G)$,
- P and D agree upon a settlement out of court for $\hat{S}$ if, and only if, $G/(Y + G) < q_P < q_D + G/(Y + G)$,
- drops the case if, and only if, $G/(Y + G) > q_P$

Figure 2 visualizes the three possible outcomes of Game 1, depending on the parameters q_D and q_P . The diagonal line represents condition (3) while the horizontal line represents condition (1). In the upper left triangle, the subgame perfect equilibrium path is (no settlement, trial).

In the lower rectangle, the case has NEV and the equilibrium path is (no settlement, no trial). In the upper right area, the parties come to a settlement

¹⁵For simplicity, we ignore ties (such as $q_P Y - (1 - q_P)G = 0$).

Figure 2: Outcomes of Game 1

payment $\hat{S}$ in equilibrium. Thus, Result 1 tells us that the case is more likely to be brought the more optimistic P is (relative to D) about his chances at trial (q_P), or if the value of the claim (Y) is high in relation to litigation cost (G).

2.3 TPC contracts before settlement negotiation: Game 2

Having examined the subgame without TPC contract, we now consider the prospect of P purchasing a TPC contract from F. The TPC contract bargaining between F and P is assumed to happen before any settlement negotiations take place. Our analysis assumes that the details of the contract are publicized to D, though not to the judge should trial ensue.¹⁶

¹⁶Different jurisdictions deal with this matter in different ways. For example, FORIS AG (see note 2), as well as its competitors, prohibit the publication of this information by a contract clause, while procedural rules in the UK require that some attention is drawn to the existence - at least - of conditional fee arrangements, see (STANBURY (2001)).

2.3.1 The subgame with TPC contracts

Game 2 consists of a contract stage where F and P negotiate over a TPC contract. The contract stage is followed by two subgames: one in which no contract has been made (this is Game 1 we have just analyzed), the other one with a TPC contract. Figure 3 shows this sequence of events. The contract stage is represented by the rectangle labeled (F, P). Following the signing of a contract, settlement negotiations start (represented by the rectangle that is labeled as P, D). If P and D come to an settlement, then payment is now denoted as S_F and the payoffs of P, D and F are $[(1 - \mu)S_F, -S_F, \mu S_F]$.

The other consequence of a TPC contract is a modification of the payoffs if settlement fails and P decides whether to proceed to trial or not: on the one hand, he no longer worries about the litigation cost, on the other he has to share his returns with F. F's share is denoted by μ , thus P receives $(1 - \mu)$. Hence, the (expected) payoffs to P, D, and F in case of a trial are $[(1 - \mu)q_P Y, -q_D(Y + G), \mu q_P Y - (1 - q_P)G]$.

Figure 3: Event tree of Game 2

As long as $\mu < 1$, a TPC contract obviously turns each case into a credible threat, so P will always sue if the parties fail to settle. D faces the expected loss $-q_D(Y + G)$. P expects a gain $(1 - \mu)q_P Y$ at trial. If the parties agree upon a settlement payment S_F , then P collects his share $(1 - \mu)S_F$.

The comparison of the trial and the settlement outcome allows to derive the threshold above which a settlement is acceptable for P. He favors a settlement to a trial if $(1 - \mu)S_F > (1 - \mu)q_P Y$. This is equivalent to $S_F > q_P Y$. Note that this threshold value is greater than in Game 1.

For D, the existence of a TPC contract has no impact on his threshold from which on a settlement is agreeable. Therefore, the bargaining range in the presence of a TPC contract is

$$]q_P Y, q_D(Y + G)[\quad (5)$$

Because $(1 - q_P)G > 0$, this interval is a subset of the bargaining range without the funding contract, see (2). In particular, the contract results in an upward shift of the lower boundary of the bargaining range corresponding to P's protection against cost. The parties will proceed to court if the bargaining range (5) is empty; i.e. when $q_P Y > q_D(Y + G)$ or, equivalently,

$$q_P > \frac{Y + G}{Y} q_D \quad (6)$$

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

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

Thereby, we have derived our second result:

Proposition 2: In the subgame of Game 2 where a TPC contract between F and P has been made,

- P proceeds to trial if, and only if, $q_P > q_D(Y + G)/Y$;
- P and D settle out of court for $\hat{S}_F$ if, and only if, $q_P < q_D(Y + G)/Y$.
- If a settlement occurs, then the agreed upon settlement payment is higher than in the subgame without a TPC contract, i.e., $\hat{S}_F > \hat{S}$.¹⁷

¹⁷This relation also holds for any other distribution of the settlement rent between P and D, due to an asymmetric bargaining solution, as long as P's share is positive.

Figure 4 demonstrates the two possible outcomes of this subgame of Game 2. The diagonal line represents condition (6). Combinations of q_P and q_D above this line lead to a trial, whereas parameters below this line motivate the parties to come to a settlement.

Comparing Figure 4 with our benchmark case in Figure 2 we see that there is no longer a lower rectangle where trial is a non-credible threat. Thus, the insurance function of the TPC contract ensures that P will always be willing to go to court, which is a necessary condition to motivate D to accept positive settlement payments. We also know that, when both games lead to settlement, the presence of a contract generates a higher gross settlement for P.

Figure 4: Outcomes of Game 2

2.3.2 Incentives to make a TPC contract

Under what circumstances will P and F find it mutually beneficial to enter into a TPC contract? To examine this question we compare the outcomes of the two possible subgames of Game 2, the one with a contingency contract and the one without. Figure 5 brings together Figure 2 and Figure 4. According to Figure 5, we have to distinguish five cases when comparing the

two subgames that start right after the contract stage in Game 2.¹⁸

Figure 5: Comparison of Games 1 and 2

In the upper left triangle of Figure 5, labeled as **a)**, both litigants are overly optimistic. Therefore, they would meet in court regardless of whether a TPC contract has been made. However, the contract increases P's expected payoff by ΔS . Thus, it would benefit P if $(1 - \mu)q_P Y > q_P Y - (1 - q_P)G$ or, equivalently, $\mu q_P Y < (1 - q_P)G$: the agreed share for F must not be "too large". F, in turn, will find it beneficial to offer a TPC contract if $\mu q_P Y - (1 - q_P)G > 0$. Clearly, this contradicts the condition for P. Thus, the equilibrium path under the parameters defining a) is (no contract, no settlement, trial): P takes the case to trial unaided.

The next case is represented by the triangle labeled **b)**. Here, the parties would settle in the absence of a TPC contract, and P's payoff would be $\hat{S}$. However, under the contract P proceeds to court, which leads to an expected payoff of $(1 - \mu)q_P Y$. P finds a contingency contract beneficial if this exceeds the settlement payoff $\hat{S}$ he receives in the absence of such a contract. The condition for F to find a contract beneficial is $\mu q_P Y > (1 - q_P)G$. It is

¹⁸Note that this analysis is based on the assumption that the amount at stake, Y , is constant. A higher amount at stake c.p. increases the number of combinations of q_P and q_D that lead to trial, whereas settlements become less frequent.

easy to show that these conditions, if they are simultaneously true, imply $q_P > G/(Y + G) + q_D$, which contradicts the conditions for case b).¹⁹ Hence, the subgame perfect equilibrium path is (no contract, settlement $\hat{S}$).

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

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

In the final triangle **e**), the parties do not settle in either Game 1 or Game 2, but for different reasons. In Game 1, the parties do not settle since the trial has NEV. In Game 2, P would proceed to trial anyway (because the contract protects him from any trial cost). If F and P do not expect a settlement, then there is no bilateral gain from a TPC contract. Thus, the subgame perfect equilibrium path is (no contract, no settlement, no trial).

The above insights concerning areas a), b) and e) allow for the following conclusion:

Proposition 3: In Game 2, a TPC contract is mutually beneficial for F and P if, and only if, P and D come to a post-contract settlement in the subsequent game, i.e. in areas c) and d) of Figure 5.

Looking back to Proposition 2, we know that a TPC contract is mutually beneficial for F and P if, and only if, $q_P < q_D(Y + G)/Y$. In this case, D and P come to a settlement result $\hat{S}_F$ which exceeds the settlement result without a contract, $\hat{S}$.

Furthermore, note that whenever it is mutually beneficial for F and P to make a TPC contract, a settlement is triggered and F does not actually have

¹⁹ $(1 - \mu)q_P Y > \hat{S}$ is equivalent to $\mu q_P Y < 0.5[q_P(Y - G) - q_D Y + (1 - q_P)G]$. With $\mu q_P Y > (1 - q_P)G$, these conditions imply $0.5[q_P(Y - G) - q_D Y + (1 - q_P)G] > (1 - q_P)G$, which is equivalent to $q_P(Y - G) - q_D Y + (1 - q_D)G > 2(1 - q_P)G$. Rearrangement leads to $q_P(Y + G) > G + q_D(Y + G)$, implying case a).

to bear the risk of having to pay litigation cost. As we shall see below, allowing plaintiffs more flexibility as to when they can contract with F alters this outcome.

3 Discussion

3.1 Settlement before TPC contract: Game 3

In this section, we consider the possibility of entering a TPC contract after the settlement negotiations have already begun. This is an option under many of the newly emerging after-the-event insurance arrangements. As we shall see for the class of arrangements under study, the outcome for F changes if potential customers are allowed to start settlement negotiations before agreeing a contingency contract.

Figure 6 shows the event tree of this new Game 3. First, the parties P and D bargain over a settlement. If they agree upon a payment, now denoted as T , then the payoffs for P, D, and F are $[T, -T, 0]$. If the parties fail to settle immediately, then they enter Game 2 as described in the previous section. Thus, Game 2 is now a subgame of Game 3, and was already shown to have five possible outcomes, represented by parameter combinations a) to e) above. In these cases, the parties would expect no TPC contract to be signed during the subsequent game if they fail to settle in the first place. Only c) and d) make a contingency contract feasible if the first-round settlement is not agreed upon. Therefore, only these parameter combinations require further analysis now.

These two sets of parameters are characterized by the condition $q_P < q_D(Y + G)/Y$. The equilibrium path in Game 2 includes a TPC contract and a settlement $\hat{S}_F$ (see Proposition 2). Given this subgame result, in Game 3 a settlement result during stage 1 is acceptable for D if $T < S_F$, and for P if $T > (1 - \mu)S_F$. Thus, the bargaining range now is $](1 - \mu)S_F, S_F[$. This range is non-empty for any value of $\mu > 0$. Thus, the parties have an incentive to settle in the first place, without actually proceeding to the contract stage. Thus, it is the mere opportunity to make a TPC contract in the subsequent game which develops an impact on the parties' behavior.

Recall that, for the parameter values defining case d), without TCP contracts being available, the parties were confined to Game 1. In the parameter set d), the case would be dropped. In Game 3, the parties are motivated to settle

the case. In case c), the parties would settle both in Game 3 and in Game 1. However, the gross settlement is increased. Again, the *threat* of a contract is sufficient to influence the behavior of the disputing parties. Without actually signing a TCP contract, its availability increase the settlement. F, however, the existence of which plays an important role in Game 3, actually receives no business.²⁰

Figure 6: Event tree of Game 3

3.2 Existence of a TPC contract as a signal

An interesting implication of our analysis involves the extent to which the existence of a contract should be revealed to an opposing litigant. We have noted that practice may differ across jurisdictions in this regard. However, in our model, the strategic effects we have derived are due to the defendant's awareness of the TPC agreement. This raises the interesting question of why insurers in Germany typically prevent this information from being divulged. It is possible that an asymmetric information model of litigation would help illuminate this issue: the insurer may be happy to signal "good news" (case strength) but not "bad news" (if it has taken on a relatively weak case). A signaling model like REINGANUM/WILDE (1986) would be a possible route for further research here.

²⁰Future work might usefully examine whether TPC contracts contain clauses restricting the amount or type of pre-contract negotiations that can have taken place prior to signing a contract.

We might furthermore ask whether a judge, modeled as a rational player, would be able to infer anything about the strength of P's case if he could observe a TPC contract and if he did not know $\{q_P, q_D\}$. If this were the case, then a clause protecting the presence of a TPC contract could make sense insofar as it protects the plaintiff from lowering his odds in court. In the context of our model, the only cases that come before the judge at trial are those in which no TPC contract has been made. Thus, even if the existence of a TPC contract is revealed to the other side, this does not necessarily imply that the judge can see this particular information. This could be different if the judge adopted a more "pro-active" attitude to case management as settlement negotiations proceeded. If he was intervening during the case, he would be able to observe the signing (or otherwise) of a TPC contract and update his beliefs using Bayes' rule. However, even in this case, he could not infer with certainty the plaintiff's subjective probability of prevailing, q_P .

3.3 Welfare effects

Another question relates to the welfare effects of the new arrangements. In order to consider this, we need to know how TPC contracts will influence levels of *ex ante* care and, therefore, the chances of an actionable event.²¹ Our model would predict an increase in this care level because of the two strategic effects identified above. First, the increased likelihood of being taken to trial automatically causes potential defendants to internalize (some of) the cost of their actions when taking care. Second, the higher settlement amounts also seem likely to achieve this in the current model. In models where *ex ante* care levels are endogenous, it is common for higher settlement amounts to reduce the number of trials and, therefore, to offset the increase in care we have just identified (see, e.g. GRAVELLE/WATERSON, 1993). The current model does not produce this because the subgame perfect equilibrium number of trials is not altered by the availability of contracts.²² Of course, the benefits of more care (and less accidents) need to be traded off against the looser screening of case merits (and the subsequent pool of weaker cases) that arises under TPC contracts: in some situations it is possible that excessive care could result. Thus, the overall welfare effect of these contracts is likely to be ambiguous - though in some settings, this should be compared with the welfare effects

²¹ *Ex ante* care levels can be quite widely defined here. While we have placed our analysis in the context of tort, one could also consider the behaviour of commercial contracting parties under contract law. See KIRSTEIN/SCHMIDTCHEN (1997).

²² This also means that there is no change in the equilibrium level of welfare from the number of trial precedents that are set.

of other measures that may restrict access to justice (like the tightening of legal aid).²³

4 Conclusions

A number of institutional developments have taken place in recent times, concerning the way in which lawyers and courts can be paid in legal services markets across Europe. Although these developments are taking place with some speed, we have noted a general tendency for them to combine some form of result-contingent payment with insurance against cost. This third party element appears necessary to provide protection against the extra cost risk imposed by British cost rules.

We have modeled, for the first time, a particular class of such arrangements: the TPC contracts emerging in Germany; noting that these are also attracting interest elsewhere in Europe. Two effects of these contracts are highlighted by the model:

- first, their ability to add credibility to an otherwise weak (or low value) case, such that it becomes profitable for a plaintiff to threaten trial;
- Second, again by shielding the plaintiff against cost, their ability to increase (gross) settlements in the event of a negotiated settlement of the case;

To the extent that these both occur in a model with risk neutral parties, they can be thought of as “strategic” effects.²⁴ In principle, the strategic effect may be so strong that the mere threat of entering into such a contract can force settlement (at improved terms) in cases that would otherwise be dropped. Since the TPC contract only serves as a credible threat and is not actually made, this would benefit the plaintiff, but not the third parties. One research question raised by our model is to what extent insurers restrict pre-contract negotiations between plaintiff and defendant (i.e., generate our Game 2 rather than Game 3).

²³Note also that our discussion assumes that social welfare places equal weight on transfers between plaintiffs, defendants and third parties, so that TPC contracts raise no distributional issues.

²⁴Following KIRSTEIN (2000).

There are a number of other ways in which the model we have presented can be extended. To begin with, a class of economic models of pre-trial bargaining have, since BEBCHUK (1984), assumed the presence of asymmetric information between the parties. This typically prevents cases from necessarily settling when gains from trade are present. HEYES/RICKMAN/TZAVARA (2001) analyze such a model in the presence of Legal Cost Insurance and endogenous *ex ante* care levels, and it would be valuable to see how the current results carry over to that setting.

This would also allow for an analysis of how TPC contracts might affect the plaintiff's credibility constraint, as analyzed by NALEBUFF (1987). One might also ask how a TPC contract affects the dynamics of settlement negotiations in a model such as SPIER (1994) to examine the influence of contingent fee contracts on the amount and timing of settlement.²⁵ It may also be fruitful to model the impact of TPC contracts on the incentives of attorneys that represent the parties.

Clearly, the ways in which result contingent payment may be combined with British cost rules and (perhaps necessarily) Legal Costs Insurance has considerable potential for further economic analysis. What is more, there is evidence that such changes can have implications for other institutional elements of legal systems. For the example of the UK, STANBURY (2001) describes how insurers are beginning to monitor and challenge the bases on which cost are assessed, while PEYSNER (2001) notes that the British rule may itself be called into question if such mechanisms as those we have analysed cannot be made to work.

With some European countries seeking to reduce public expenditures on legal aid, and place more reliance on private insurance alternatives, the insights that economic analysis can generate are likely to inform an increasingly important policy debate.

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²⁵RICKMAN (1999) presents a dynamic model of pre-trial bargaining with contingent fees.

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