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Legal expenses insurance, risk aversion and litigation

Anthony Heyes^a, Neil Rickman^{b,c,*}, Dionisia Tzavara^b

^a Royal Holloway College, University of London, UK

^b Department of Economics, University of Surrey, Guildford GU2 7XH, UK

^c CEPR, Guildford, GU2 7XH, UK

Abstract

The risks involved in litigation are well documented; they include the risk of incurring legal expenses. While much literature focuses on contingent fees as a mechanism for litigants to shift this risk, there is little work on legal expenses insurance—the dominant means of shifting this risk in Europe. In our model, a risk averse plaintiff may purchase legal expenses insurance. The defendant makes a single settlement offer but is uninformed about the plaintiff's degree of risk aversion. We investigate the effects of insurance cover on settlement amounts, settlement probabilities, the volume of accidents and the ex ante volume of trials. We also investigate the insurance decision. We find that more insurance hardens the plaintiff's negotiating stance and increases the defendant's level of care, but that the overall effects on other variables of interest depend on the plaintiff's risk aversion. Insurance can increase or decrease ex ante welfare.

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1. Introduction

It is well-known that litigation can expose the parties involved to considerable risk. Not only does trial leave the loser bearing whatever financial loss is the object of the case, but some jurisdictions also require the loser to meet all the costs of litigation, including those of the winner (the British indemnity rule). The presence of such risks has encouraged several market responses. In the US, it is common for individual plaintiffs to retain lawyers

* Corresponding author. Tel: +44-483-689-380; fax: +44-483-689-548.

E-mail address: n.rickman@surrey.ac.uk (N. Rickman).

on a contingent basis, thereby shifting some risk on costs to their agent. Alternatively, the majority of European jurisdictions have well-developed insurance markets where protection against the risk of legal expense can be purchased (see Prais, 1995). In England and Wales, although the market for such legal expenses insurance (LEI) has developed slowly (see Rickman & Gray, 1995), this position is changing as policy makers look to substitute private insurance for the increasingly expensive social insurance against legal expense provided by legal aid (see Lord Chancellor, 1998).

Despite this European emphasis on legal expenses insurance, as opposed to contingent fees, research on the economics of litigation has focused strongly on the latter;¹ exceptions are Kirstein (2000) and van Velthoven and van Wijck (2001). Indeed, more generally, although risk is endemic in litigation, risk aversion features in very few formal models of settlement bargaining. In this paper, we seek to address both matters by analysing the effects of legal expenses insurance on litigation, under circumstances where the defendant is uninformed about the plaintiff's degree of risk aversion (in contrast to the complete information, risk neutral settings of Kirstein, 2000; van Velthoven & van Wijck, 2001).

In principle, the effects of LEI are manifold and will include the signaling associated with an insurer being willing to allow a policy holder to pursue a case (this will usually be done after a merits test) and the interactions between insurance purchase and self-protection measures which individuals can undertake (see Ehrlich & Becker, 1972). Our model abstracts from these, focusing instead on settlement behaviour, care decisions (and hence the number of accidents), the volume of trials and on how the plaintiff's purchase decision is affected by these. Such matters have received attention in British and European policy debate, where the ability of alternative funding arrangements to enhance access to justice without congesting the legal system has been a key concern.²

As mentioned above, a feature of our model is the explicit treatment of risk aversion in modeling pre-trial behaviour. This is often ignored by literature which seeks to model settlement negotiations. Exceptions include Farmer and Pecorino (1994) and Swanson and Mason (1998).³ Like these authors, we assume that the defendant makes a settlement offer when uninformed about the plaintiff's degree of risk aversion. We follow Swanson and Mason (1998) by explicitly modeling settlement negotiations in the presence of such risk aversion. However, apart from its focus on LEI, our paper also differs by considering initial care decisions and, therefore, the welfare effects of such insurance. Gravelle (1989) also models a risk averse plaintiff and initial care decisions. Unlike our paper, however, he assumes that the defendant is aware of the plaintiff's degree of risk aversion and the focus of his model is cost allocation rules.⁴

¹ There is an established literature on contingent fees: e.g. Patricia Munch Danzon (1983), Halpern and Turnbull (1983), Rubinfeld and Scotchmer (1993), Dana and Spier (1993), Rickman (1999). See the survey in Rickman (1994).

² In Britain for example, the common law crimes of champerty and maintenance prevented third parties (except the State) from funding litigation because of such concerns. In Germany, these concerns have surrounded LEI itself: see Jogodzinski, Raiser, and Riehl (1994).

³ A more general literature looks at bargaining with risk aversion and demonstrates the complexities that can arise with even relatively simple extensive forms: see Osborne (1985), Rubinstein, Safra, and Thomson (1992).

⁴ Another interesting paper that considers pre-trial bargaining with risk aversion is Phillips, Hawkins, and Flemming (1975).

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