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THE MULTIPLICATION EFFECT OF LEGAL INSURANCE

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Because legal insurance policies cover the expenses of plaintiffs in bringing legal claims, such policies increase the risk of negligent or careless acts by tortfeasors. For this reason, potential tortfeasors would prefer to avoid injuring holders of legal insurance policies. Since insurance coverage (or lack thereof) is not observable to a tortfeasor prior to an accident, tortfeasors can never exercise this preference ex ante. As a result, insured tort victims provide deterrence benefits to those that are uninsured by increasing the overall expected costs of engaging in negligent, harmful behavior. In magnifying a tort offender's overall risk of facing legal action, this multiplication effect of insurance policies enhances deterrence, inducing increased overall safety levels.

Unfortunately, however, the multiplication effect of legal insurance reduces the demand for legal expense insurance policies. Because policyholders do not capture the full benefits of legal insurance policies on safety, too few individuals sign up for such policies. As a result of this public good effect, the average price of insurance policies remains high, which reduces the

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demand for legal expense insurance policies. In revealing these overlooked collective action issues, this Article opens new inroads for policy discussions regarding legal insurance markets.

INTRODUCTION

Whenever litigation costs discourage a plaintiff from pursuing a rightful legal claim, the deterrent effect of the legal system is undermined.[1]

The burden of litigation is reduced if a potential litigant can take out insurance policies against prospective litigation.[2] Insurance policies commonly cover the costs of defending against a lawsuit (*passive* insurance policies), but insurance

1. Plaintiffs do not usually take into account the positive effect of their lawsuits on the deterrent function of the tort system. This problem will be especially acute if the social benefits of a lawsuit outweigh the private gains to the plaintiff. *See* Steven Shavell, *The Social Versus the Private Incentive to Bring Suit in a Costly Legal System*, 11 J. LEGAL STUD. 333 (1982). A recent study estimates that tort victims pursue legal recourse in barely one out of ten accidents. *See* DEBORAH HENSLER ET AL., COMPENSATION FOR ACCIDENTAL INJURIES IN THE UNITED STATES 175 (2005). Note, however, that proposals to stimulate legal claims must also take into account the additional costs of litigation that might result. Shavell, *supra*, at 336 (explaining the potential misalignment between private and social incentives to bring lawsuits).

2. *See infra* Part I.

companies may also offer policies that cover the expenses of plaintiffs to bring forth and litigate a claim in court (*active* insurance policies). By improving access to the justice system, legal expense insurance increases the overall deterrent effect of the tort system.[3] If active legal insurance policy subscriptions are widespread, victims are more likely to be able to afford the legal expenses to pursue a valid claim in court and hold tortfeasors accountable.[4] Consequently, by increasing the expected costs of negligent behavior, legal expense insurance induces careful behavior and potentially reduces the overall amount of accidents in society.[5]

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3. *See* Michael Trebilcock, *Innovations in Service Delivery*, ONTARIO MINISTRY OF THE ATTORNEY GENERAL, http://www.attorneygeneral.jus.gov.on.ca/english/about/pubs/trebilcock/section7.asp (last visited Dec. 30, 2011) ("[L]egal insurance may be one means to significantly improve access to justice . . . ."); *see also* Alastair Gray & Neil Rickman, *The Role of Legal Expenses Insurance in Securing Access to the Legal Services Market*, *in* REFORM OF CIVIL PROCEDURE: ESSAYS ON 'ACCESS TO JUSTICE', 305, 310 (A.A.S. Zuckerman & Ross Cranston eds., 1995).

4. Trebilcock, *supra* note 3*; see also* Gray & Rickman, *supra* note 3.

5. An expanding body of empirical research substantiates the deterrent effect of tort law. First, studies have revealed the relation between product liability and safety improvements. *See, e.g.*, DON DEWEES ET AL., EXPLORING THE DOMAIN OF ACCIDENT LAW: TAKING THE FACTS SERIOUSLY 198 (1996) (reporting studies showing that over one in three companies had improved the safety of their products and almost half had improved product usage and warranties as a result of product liability law). Second, when states eliminated liability insurance in favor of no-fault systems, several studies report that this switch caused a statistically significant increase in auto accidents or fatalities. *See, e.g.*, J. David Cummins et al., *The Incentive Effects of No-Fault Automobile Insurance*, 44 J.L. & ECON. 427, 454–55 (2001) (linking no-fault systems and higher fatality rates in various states in the United States if negligence assignment under tort is sufficiently responsive to the driver's level of care); Elisabeth M. Landes, *Insurance, Liability, and Accidents: A Theoretical and Empirical Investigation of the Effect of No-Fault Accidents*, 25 J.L. & ECON. 49, 49–50 (1982) (reporting increased accident losses in no-fault states in various U.S. states); R. Ian McEwin, *No-Fault and Road Accidents: Some Australasian Evidence*, 9 INT'L REV. L. & ECON. 13, 14 (1989) (finding similar effects in New Zealand). Deterrent effects have also been observed in the trend towards more stringent regulation of alcohol use and driving. *See, e.g.*, Frank J. Chaloupka et al., *Alcohol-Control Policies and Motor-Vehicle Fatalities*, 22 J. LEGAL STUD. 161, 184 (1993); Lan Liang et al., *Precaution, Compensation, and Threats of Sanction: The Case of Alcohol Servers*, 24 INT'L REV. L. & ECON. 49, 67–68 (2004). For a summary of the research on the deterrent effects of tort law, see Ben C.J. Van Velthoven, *Empirics of Tort*, *in* 1 ENCYCLOPEDIA OF LAW AND ECONOMICS, TORT LAW AND ECONOMICS 453 (Michael Faure ed., 2d ed. 2009).

Despite these benefits, active legal insurance policies are surprisingly uncommon. By most accounts, only a very small fraction of U.S. households purchase legal expense insurance policies that cover the costs of bringing lawsuits.[6] Similarly, while legal expense insurance markets are growing in Europe, active legal insurance policies represent only one percent of total premiums there.

The scarcity of active legal expense insurance coverage is puzzling. The availability of alternative instruments that increase access to justice, such as contingency fee arrangements and public legal aid arrangements cannot explain the dearth of coverage observed today. While contingency fee arrangements may reduce the need for legal expense insurance, legal insurance policies are also uncommon in countries where contingency fees are prohibited.[7] Similarly, legal expense insurance policies are not widely subscribed even in countries that do not provide public legal aid programs.[8]

This Article explains the low demand for legal expense insurance coverage by identifying an important and currently

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6. Most insurance policies in the United States involve prepaid plans for predictable and specified events that are low-cost but occur with high frequency (e.g., simple divorces, wills, and estates). These prepaid plans rarely offer assistance for complex legal problems (although some offer discounts on private lawyer services for more complex matters). *See* Francis Regan, *Whatever Happened To Legal Expense Insurance?*, 26 ALTERNATIVE L.J. 293, 295 (2001); *see also* GEOFFREY MCGOVERN ET AL., THIRD-PARTY LITIGATION FUNDING AND CLAIM TRANSFER (2010) (ebook) ("'Before-the-event' and 'after-the-event' legal insurance policies are not common in the United States. . . ."); Michelle Boardman, *Insurers Defend and Third Parties Fund: A Comparison of Litigation Participation*, 8 J.L. ECON. & POL'Y 673, 674 (2012) ("Litigation expense insurance is not yet an American phenomenon. . . ."); Matthias Kilian, *Alternatives to Public Provision: The Role of Legal Expenses Insurance in Broadening Access to Justice: The German Experience*, 30 J.L. & SOC'Y 31, 36 (2003) (reporting U.S. data on legal insurance coverage).

7. In many civil law countries contingency fees are prohibited. In Belgium, for instance, contingency fee agreements are prohibited even though merely 15% of the population is covered by public legal aid. Historically, the number of individuals with legal insurance in Belgium has been extremely low. In 2007, the Minister of Justice and the insurance companies agreed to set up a general legal expenses insurance system. For an annual subscription of _144 the system entitles an individual to costless legal aid by a lawyer. Only 6.7% of the population has enrolled for the program. Note that the scope of the legal matters covered by this insurance is rather limited. *See* Int'l Legal Aid Grp. Conf., *National Report: Belgium* (2009).

8. Gray & Rickman, *supra* note 3, at 315.

overlooked beneficial public good attribute of legal expense insurance. Due to the nature of accidents and the unobservable nature of insurance coverage ex ante, tort offenders are typically not able to distinguish or select between potential victims who have taken out a legal insurance policy and those who have not. While a potential tort offender might want to avoid getting involved in an accident with holders of legal expense insurance policies (i.e., those who can afford to pursue legal action more easily), tortfeasors are not able exercise this preference ex ante since an individual's insurance coverage (or lack thereof) is not observable to a tort offender prior to an accident. As a result, every additional policyholder increases the average likelihood that a negligent offender will be held accountable for his or her tortious actions. In other words, even if not every potential victim is insured to bring legal claims, those that are insured provide deterrence benefits to everyone else by increasing the overall expected costs of engaging in negligent, harmful behavior. By increasing tortfeasors' overall risk of facing legal action this multiplication effect of insurance policies significantly enhances deterrence and the bite of the tort system in general.[9] The capacity of legal insurance policies to spread out the deterrence effects across society—even if not everyone is covered by insurance—is socially valuable.

Paradoxically, however, the multiplication effect of legal insurance policies reduces the *demand* for legal insurance policies. Because the ex ante deterrent effect of any individual insurance policy is shared with all other potential accident victims—regardless of whether they are insured or not—individual policyholders do not capture the full benefits of their policies on deterrence; instead they subsidize the deterrence benefits of other members of the public who are uninsured.

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9. The concept of a multiplication effect was introduced in a paper discussing the relative benefits of carrots versus sticks as legal incentives. *See* Gerrit De Geest & Giuseppe Dari-Mattiacci, *The Rise of Carrots and the Decline of Sticks*, 80 U. CHI. L. REV. 341 (2013). Although a punishment can be applied only once, the threat to punish can be repeated several times. This is possible because, when parties comply, the punishment is not applied and can thus be used to support a new threat. *Id.* at 361–62. On the choice between subsidies and taxes in making policy, see also Brian Galle, *The Tragedy of the Carrots: Economics & Politics in the Choice of Price Instruments*, 64 STAN. L. REV. 797 (2012).

Because individuals fail to consider the external deterrence benefits of legal insurance, less than the optimal number of individuals take out insurance policies. As a result of this public good aspect of legal expense insurance, the average price of such policies remains high, which further reduces demand. The situation resembles a collective action problem: since everyone necessarily shares in the beneficial deterrent effect of insurance, not enough individuals voluntarily take out such policies, and much of the potential social value of legal insurance (the potential deterrence benefits on the tort system) remains unexploited.[10]

Additionally, legal insurance markets are plagued by a second collective action problem. Specifically, because all insurance companies share the overall benefits (deterrence and reduced accident costs) that result if one or more companies offer legal expense insurance, legal insurance markets face a public good issue on the supply side as well. As a result of the modest demand by consumers and the positive externalities for competitors that do not offer legal insurance, most insurance companies do not actively promote legal expense insurance policies.

This Article proceeds as follows: Part I provides a concise background to legal insurance markets. Part II describes the conventional challenges to insurance markets. Part III first describes the beneficial multiplication effect of legal expense insurance before analyzing the hereto-overlooked collective action issue of legal insurance markets and its effect on the demand for legal insurance. We also describe similarities to historical prosecution societies and more recent instruments such as Lojack devices. Part IV discusses supply side issues in legal insurance markets. Part V formulates policy recommendations, including mandatory subrogation, providing insurance incentives, and compulsory insurance.

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10. For classic descriptions on the public good problem, see, for example, Paul A. Samuelson, *The Pure Theory of Public Expenditure*, 36 REV. ECON. & STAT. 387 (1954), and Harold Demsetz, *The Private Production of Public Goods*, 13 J.L. & ECON. 293 (1970).

I.
LEGAL EXPENSE INSURANCE IN CONTEXT

Most individuals are risk-averse.[11] When presented with a choice between a certain loss of $10 over a 10% chance of losing $100, individuals prefer the former option even though the expected value of these losses is the same.[12] For this reason, insurance policies are an attractive option for risk-averse individuals.[13] By making premium payments on a periodic basis, "insurance allows people to shift money from times when they do not need it very much to times when they need it much more."[14] In the area of torts, for instance, first-party damage insurance provides potential accident victims reassurance that they will recoup some of the costs incurred in case of an accident.

Tort accidents often raise important legal questions or factual matters relating to the level of precaution taken, safety measures and other issues that determine liability. Because legal procedures on tort liability are costly, most standard insurance policies include coverage for legal assistance. Legal expense insurance, also known as legal cost insurance, legal protection insurance, or simply legal insurance, is a voluntary private insurance instrument that covers the costs of lawsuits.[15] Although the expenses involved with defending policyholders against tort suits are included in most personal, professional, and commercial liability insurance policies (passive legal insurance), the costs of *bringing* legal suits (active insurance) is rarely included in insurance policies. Although generally avail-

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11. Because individuals are risk-averse, money has a declining marginal utility. As a result, "insurance is a more efficient way than savings to equalize the marginal utility of consumption over time." Tom Baker & Peter Siegelman, *Law and Economics After the Behavioral Turn: Learning from Insurance* 6 (Petrie-Flom Center, Working Paper, 2011).

12. *See generally* STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW (1987).

13. In a world with perfect information and no transaction costs, everyone would be better off insuring against all risks. *See* Kenneth J. Arrow, *Insurance, Risk and Resource Allocation, in* ESSAYS IN THE THEORY OF RISK BEARING 134 (1971) (discussing the problems created by adverse selection and moral hazard).

14. Baker & Siegelman, *supra* note 11, at 6.

15. First and foremost, coverage typically includes legal fees charged (including expenses incurred) by a lawyer or law firm representing the policyholder.

able in developed insurance markets,[16] individuals in the United States rarely take out legal insurance policies that cover the cost of bringing litigation.[17] Similarly, in most industrialized nations a relatively small fraction of households take out legal insurance policies. Although legal insurance markets are growing in Europe,[18] legal insurance coverage represents only one percent of total premiums.[19] Similarly, legal insurance coverage has not flourished in most countries, including France,[20] the United Kingdom, Australia, and New Zealand.[21]

The lack of success of legal insurance policies is intriguing. Legal expense insurance provides considerable benefits to policyholders. First, legal insurance shares in common with other insurance instruments the benefit of reducing one's exposure to risk. Since litigation is a small chance event with po-

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16. Vivien Prais, *Legal Expenses Insurance*, *in* REFORM OF CIVIL PROCEDURE, *supra* note 3, at 431.

17. *See* sources cited *supra* note 6 and accompanying text.

18. In some countries, including Hungary, Luxemburg, Portugal, and Turkey, legal insurance coverage has in fact declined between 2000 and 2008. *See* CENTRE D'ETUDES D'ASSURANCE, EUROPEAN INSURANCE IN FIGURES (2009), http://www.argusdelassurance.com/mediatheque/5/1/6/000014615.pdf.

19. *Id.*; *see also* Michael Faure & Jef De Mot, *Comparing Third-Party Financing of Litigation and Legal Expenses Insurance*, 8 J.L. ECON. & POL'Y 743, 751 (2012) (comparing legal insurance to third-party financing and concluding that legal insurance is not as widespread in Europe as is sometimes alleged). One apparent exception is Sweden. While 97% of Swedes are covered by legal expense insurance, this high coverage is due to the fact that legal expense insurance is automatically added onto other insurance policies with a high market penetration (such as housing insurance). Furthermore, as a compulsory add-on insurance, such legal expense insurance policies typically restrict legal assistance to a relatively narrow range of legal claims. *See* C.M.C. VAN ZEELAND & J.M. BARENDRECHT, LEGAL AID SYSTEMS COMPARED (2003); Matthias Killian & Francis Regan, *Legal Expenses Insurance and Legal Aid—Two Sides of the Same Coin? The Experience from Germany and Sweden*, 11 INT'L J. LEGAL PROF. 233, 250 (2004); Francis Regan, *The Swedish Legal Services Policy Remix: The Shift from Public Legal Aid to Private Legal Expense Insurance*, 30 J.L. & SOC'Y 49 (2003).

20. For details see BERNARD CERVEAU, L'ASSURANCE DE PROTECTION JURIDIQUE: MARCHÉ, GARANTIES, PERSPECTIVES (L'Argus de l'Assurance ed., 2006).

21. Regan, *The Swedish Legal Services Policy Remix, supra* note 19, at 50–51. A study by the Ministry of Justice on the market for "before the event" insurance confirms this trend in the United Kingdom as well. OONA MCDONALD, IAN WINTERS & MIKE HARMER, THE MARKET FOR 'BTE' LEGAL EXPENSES INSURANCE, MINISTRY OF JUSTICE 51–56 (2007).

tentially substantial costs, risk-averse individuals stand to benefit from legal insurance coverage.[22] Second, legal insurance policies enhance a plaintiff's bargaining position.[23] Because the defendant is aware that an insurance provider will reimburse the plaintiff's litigation costs, the threat of litigation becomes more salient to a tortfeasor. As a result, insured defendants are more likely to receive fair settlement offers.

To illustrate the benefit that an active legal insurance policy confers to a subscriber, consider the following numerical example. If there is a 50% probability of obtaining $1000 in court and the legal costs are $300, the expected value of the plaintiff's legal claim is $200 (*50% x 1000 – 300*). The defendant's expected costs of the claim are $800 (*50% x 1000 + 300*). The claim will be settled if the parties can agree on a number that is within the bargaining range of the plaintiff's minimum settlement amount ($200) and the defendants maximum offer ($800). In an equal division of the surplus, the defendant and plaintiff would settle the claim at $500.[24] If, however, the plaintiff's claim is covered by a legal insurance policy, the plaintiff is in a stronger bargaining position given that the litigation costs are a concern to the defendant (*50% x 1000 + 300 = 800*) but not to the plaintiff (*50% x 1000 = 500*). In other words, if litigation costs are covered by legal expense insurance, a rational plaintiff will not settle at an amount below $500. In that case, an equal division of the surplus between the parties is a settlement amount of $650.

Moreover, society also benefits if legal insurance is widespread. Whenever, in the absence of legal insurance, a plaintiff lacks the resources to pursue a valid legal claim in court, the deterrent effect of the tort system is reduced.[25] Empirical re-

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22. Empirical research suggests that individuals are risk-averse when facing losses with modest probabilities. *See* Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk,* 47 ECONOMETRICA 263 (1979).

23. Roland Kirstein, *Risk Neutrality and Strategic Insurance,* 25 GENEVA PAPERS ON RISK & INSURANCE 251, 252 (2000).

24. Behavioral research suggests that equal divisions can be a focal point in negotiations since they align with pre-existing notions of fairness among the parties. *See, e.g.*, Matthew Rabin, *Incorporating Fairness in Game Theory and Economics*, 83 AM. ECON. REV. 1281 (1993).

25. Legal insurance can be socially costly, however, if it induces frivolous lawsuits, especially if costly litigation forces defendants into accepting settlements for claims with little or no merit. This risk can be reduced by procedu-

search suggests that this is an acute problem in various areas of tort law. Empirical research shows that a very small percentage of injured Americans pursue legal recourse against tortfeasors.[26] In the area of medical malpractice, for instance, research shows that, contrary to public perception,[27] many legitimate cases are not pursued.[28] Moreover, victims are not always fully compensated by courts.[29] This has a potentially dev-

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ral safeguards against frivolous litigation and the fact that defendants often carry litigation insurance. Finally the intervention by insurance companies mitigates this risk considerably. *See infra* Section IV.A.

26. *See* HENSLER ET AL., *supra* note 1, at 175 (observing that only about 10% of those who suffer from accidents file suit).

27. It is common to hear claims that the United States suffers from excessive tort litigation. *See, e.g.*, PHILLIP K. HOWARD, THE DEATH OF COMMON SENSE: HOW LAW IS SUFFOCATING AMERICA (1996) (claiming that the law is suffocating the country). Contrary to this popular wisdom, many reputed scholars have noted that the so-called litigation explosion in the United States in the last four decades is a myth. *See, e.g.*, John T. Nockleby, *How to Manufacture a Crisis: Evaluating Empirical Claims Behind "Tort Reform"*, 86 OR. L. REV. 533, 537–41, 550–51 (providing evidence that increased tort filings were caused by population growth and examples of stories about tort law that turned out to be false)*; see also* WILLIAM HALTOM & MICHAEL MCCANN, DISTORTING THE LAW: POLITICS, MEDIA, AND THE LITIGATION CRISIS (2004) (offering evidence that the media and interest groups have greatly overstated unrepresentative stories about tort law); Richard A. Posner, *Demand and Supply Trends in Federal and State Courts over the Last Half Century*, 8 J. APP. PRAC. & PROCESS 133 (2006) (empirical study reporting a drop off of tort litigation and damage awards since the 1980s). A recent study found no association between tort law and economic harm. On the contrary, a strong relationship between pro-plaintiff tort law and economic growth was observed. Frank B. Cross, *Tort Law and the American Economy*, 96 MINN. L. REV. 28 (2011) (examining the effects of tort law using indices created by two pro-defendant organizations: the United States Chamber of Commerce and the Pacific Research Institute).

28. *See* Lori B. Andrews, *Studying Medical Error in Situ: Implications for Malpractice Law and Policy*, 54 DEPAUL L. REV. 357, 370 (2005) (reporting that about 1.2% of patients who suffered a medical error filed suit); David M. Studdert et al., *Negligent Care and Malpractice Claiming Behavior in Utah and Colorado,* 38 MED. CARE 250, 250 (2000) (reporting that 97% of those patients who suffered a negligent injury did not sue). For an overview of these and similar studies, see David A. Hyman & Charles Silver, *Medical Malpractice Litigation and Tort Reform: It's the Incentives, Stupid*, 59 VAND. L. REV. 1085, 1089–91 (2006).

29. *See, e.g.*, ROBERT A. KAGAN, ADVERSARIAL LEGALISM: THE AMERICAN WAY OF LAW 140 (2001) (finding that most malpractice actions containing strong legal claims result in compensation that does not even cover the victim's economic losses)*; see also* W. Kip Viscusi, *Toward a Diminished Role for*

astating impact on public safety.[30] In chemical industries for instance, researchers have linked chemical pollution safety issues to a lack of litigation and accountability.[31] Although tort liability has reduced chemical hazards to some degree, acute chemical injuries and chronic diseases due to chemical exposure remain largely unaccounted.[32]

To illustrate the deterrent effect of legal insurance, consider a second numerical example. A plaintiff has a negative expected value claim if, for instance, there is a 50% probability of obtaining $500 in court and the legal costs are $300. If, however, the plaintiff's claim is covered by legal insurance, the reduction of the plaintiff's litigation costs turns a negative value claim (*50% x 500 – 300 = -50*) into a positive value claim (*50% x 500 = +250*). If legal insurance is widespread, potential tort offenders will realize that it is more likely that they will be held accountable for their actions,[33] which might increase careful behavior and reduce the overall amount of accidents in society.[34] Overall, by increasing accountability for negligent behavior, legal expense insurance benefits individual policy subscribers as well as the general public.[35]

Tort Liability: Social Insurance, Government Regulation, and Contemporary Risks to Health and Safety, 6 YALE J. ON REG. 65, 95–97 (1989) (reporting judgments and settlements in product liability litigation which do not cover the actual harm suffered by the victim).

30. *See* Richard L. Abel, *The Real Tort Crisis—Too Few Claims*, 48 OHIO ST. L.J. 443, 447, 460 (1987); *see also* Michael J. Saks, *Do We Really Know Anything About the Behavior of the Tort Litigation System—and Why Not?*, 140 U. PA. L. REV., 1147, 1183–89 (1992).

31. *See* Nicholas A. Ashford & Robert F. Stone, *Liability, Innovation, and Safety in the Chemical Industry*, *in* THE LIABILITY MAZE: THE IMPACT OF LIABILITY LAW ON SAFETY AND INNOVATION 367 (Peter W. Huber & Robert E. Litan eds., 1991) (developing an optimal deterrence benchmark, reflecting on the total social costs of chemical harm, and evaluating the liability costs to the chemical industry in relation to this benchmark).

32. *Id.* at 368.

33. *Id.* at 377.

34. *See generally* SHAVELL, *supra* note 12 (analyzing the various incentive effects of the tort system on behavior).

35. One reservation is that when accidents are bilateral (victims also influence the accident rate), insurance might create careless behavior. This effect, also known as moral hazard, applies most strongly to general damage insurance. Moreover, insurance companies and tort rules can help reduce moral hazards by increasing the accountability of victims (for instance when courts apply comparative negligence or when insurance companies include deductibles). *Id.* at 26–31.

II.
Challenges to Legal Insurance Markets: Demand Side

Despite the clear advantages, legal expense insurance policies are not widespread.[36] Several explanations have been offered to understand the curious scarcity of legal expense insurance. First, contingency fees may reduce the need for legal expense insurance.[37] Indeed, contingency fees are functionally similar to insurance policies in that they remove litigation costs from consideration for the individual plaintiff: the plaintiff lawyer carries the burden of litigation costs under a contingency fee arrangement and the insurance company finances the litigation. There are some differences however; a plaintiff will need to retain a lawyer who is willing to take the case on a contingency fee basis. While insurance companies are well suited to spread out litigation costs across a large group of policyholders ex ante (so called "before the accident events"), lawyers will be reluctant to take on ex post disputes ("after the accident events") that involve relatively high litigation costs, especially since the contingency fee arrangement provides the lawyer only a fraction of the potential damage award.[38] In other words, contingency fees are not a perfect substitute for legal insurance. Additionally, legal expense insurance is infrequent in countries where only a modest fraction of the population is eligible for legal aid and where contingency fees are prohibited.[39]

Second, the low demand for legal insurance is sometimes attributed to the fact that individuals tend to underestimate both the probability that they will be involved in a legal case[40] and the expenses involved in litigation,[41] or incorrectly assume

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36. *See supra* Part I.

37. *See supra* Part I.

38. Accordingly, contingency fees do not turn negative value suits into positive value lawsuits. By contrast, since legal expense insurance removes litigation costs from an individual policyholder's consideration, the plaintiff will have a more credible claim. Of course, the insurance company will need to sign off on the litigation, but insurance companies might be able to spread the costs of litigation across a larger pool of disputes than any individual lawyer or law firm working on a contingency fee. Note that, even if insurance companies regularly settle tort disputes, the deterrent effect of the policies is sustained for the most part.

39. Int'l Legal Aid Grp. Conf., *supra* note 7.

40. Regan, *supra* note 6, at 295.

41. Gray & Rickman, *supra* note 3, at 310.

that they are covered by legal aid policies.[42] If individuals underestimate the potential costs of adverse events, this reduces their willingness to incur the expense of monthly premiums that cover legal insurance.[43] On the other hand, behavioral research suggests that individuals are very sensitive to salient risks involving high potential costs.[44] This certainly applies to litigation since, when reporting on legal issues, mainstream media outlets tend to focus disproportionally on the most salient legal stories that involve outliers encompassing, for instance, exorbitant legal fees, massive jury awards, and excessive litigation costs.[45] As a result, it is unlikely the low demand for legal insurance can be attributed solely to behavioral dispositions, such as underestimation of tort risk and litigation costs.

To summarize, although the conventional explanations regarding the scarcity of legal insurance have some merit, they cannot fully explain, nor justify, the uncommonness of legal expense insurance. As we explain below, the scarcity of legal expense insurance cannot be fully understood without recognizing the multiplication effect of legal insurance.

III.
The Multiplication Effect of Legal Expense Insurance

A. *Basic Effect*

In many potential accident situations, individuals make decisions that affect the relative likelihood and magnitude of harm inflicted on potential victims. For instance when deciding to engage in a relatively dangerous activity (e.g., street car racing) in one neighborhood over another, harm is more likely to be inflicted on residents in the designated neighborhood as opposed to the non-selected neighborhoods. But even in situations where individuals control how and where they conduct dangerous activities, potential tort offenders are not

42. *Id.* at 315.

43. For a review of "demand side anomalies" in the insurance market, see Howard Kunreuther, Mark Pauly & Stacy McMorrow, Insurance and Behavioral Economics: Improving Decisions in the Most Misunderstood Industry (2013).

44. Cass R. Sunstein & Richard Zeckhauser, *Overreaction to Fearsome Risks*, 48 Envtl. & Resource Econ. 435 (2011).

45. Saks, *supra* note 30, at 1161 (documenting how news media outlets focus on outliers in legal news reports).

able to distinguish between potential victims who have taken out a legal insurance policy and those who have not. Insurance coverage is unobservable before any given accident. Although a potential tort offender might want to avoid injuring insurance policyholders (who can afford to pursue legal action more easily), they can never exercise this preference ex ante.

Since tort offenders are unable to distinguish ex ante between potential plaintiffs who have taken out a legal insurance policy and those who have not, every additional holder of legal expense insurance increases the probability that a negligent offender will be held accountable. Even if not every potential victim is insured to bring legal claims, those that are insured provide benefits to others since every additional policy increases the overall expected costs of engaging in negligent, harmful behavior. This multiplication effect of insurance policies significantly enhances deterrence and the bite of the tort system.

The following stylized example illustrates the multiplication effect and its consequences. Assume a world in which there is just one potential injurer and ten potential victims. The injurer must decide how much care he or she will exercise (investment in precautions, etc.) when engaging in an activity. If the injurer takes no care, each victim suffers a loss of $100 with certainty. If the injurer takes care (at a cost of $10 to the potential injurer), victims will not incur any harm. Assume further that the victim would need to spend $150 to successfully pursue the legal claim. The courts apply a rule of strict liability.[46] Only two out of ten potential victims purchase legal insurance coverage. Imagine first a scenario where the injurer knows who is insured and who is not. If so, the injurer will take care (spend $10) in order to prevent an accident involving the two individuals that are insured (because the cost of care is smaller than the damages), but will forsake these investments with regard to the uninsured victims (who will not file suit because their claim has negative expected value). As a result, the two insured victims will not suffer any harm, while the other eight victims will each suffer $100 in harm. In a second, more realistic scenario the injurer cannot distinguish before the accident between insured and uninsured victims. Consequently,

46. This example also illustrates that the multiplication effect occurs if a rule of negligence applies.

for each potential victim that is harmed, the injurer faces a 20% chance that a legal claim will be pursued. This encourages the injurer to invest in precautions at all times, as it pertains to all ten potential victims (both insured and uninsured). Investing in precautions costs only $10. By contrast, the expected costs of engaging in the activity without taking any precautions is $20 since there is a 20% probability that any given victim will pursue legal action in which case the court will award $100. This example illustrates how the difficulty of distinguishing across insured and uninsured defendants has a magnifying effect of every individual legal insurance policy. Next we address a demand side complication that undermines the full potential of the beneficial multiplication effect described in this part.

B. *Multiplication as a Collective Action Problem*

Despite the positive effect on deterrence, the multiplication effect of legal insurance reduces the demand for legal expense insurance coverage. Because the ex ante deterrent effect of any individual insurance policy is shared with all other potential accident victims—regardless of being insured—individual policyholders do not capture the full benefits of their policies on deterrence; instead they subsidize the deterrence benefits of other members of the public that are uninsured. Because individuals fail to consider the external deterrence benefits of legal insurance, fewer individuals take out insurance policies. As a result of this public good problem, the average price of such policies is high,[47] which further reduces demand. The situation resembles a collective action problem: since everyone necessarily shares in the beneficial deterrent effect of insurance, not enough individuals voluntarily take out such policies and much of the social value (the potential deterrence benefits of insurance on the tort system) remains unexploited.[48]

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47. Low insurance premiums require that the risk be pooled across a large group of individual policyholders. In California, for instance, earthquake insurance premiums are relatively high because only 17% of homeowners have taken out such policies. In order to lower premiums, insurance companies would need to be able to spread the risk across a greater number of policyholders. *See* Liz Pulliam Weston, *Rethinking Your Stance on Earthquake Coverage*, L.A. Times, July 15, 2013.

48. *See supra* sources cited note 30 and accompanying text.

A numerical example may illustrate this collective action issue among potential policyholders. Suppose that all potential victims of a given accident have purchased first party damage insurance that covers all harm. Every policyholder pays a premium of $500. Additionally, insurance companies offer legal expense insurance. Victims must decide whether they will take out the additional policy.[49] If 50% of the potential victims purchase legal insurance coverage, more legal claims will be pursued—by removing legal costs, legal insurance turns negative expected value lawsuits into credible, positive value claims.[50] This, in turn, will induce more careful behavior among potential tort offenders and likely reduce accident frequency. Since insurance premiums reflect the overall expected harm, the reduction of accidents will lower damage insurance premiums overall. Assume that damage insurance premiums decrease to $450. The premium for the legal insurance is $75. Policyholders who opt for both damage insurance and legal insurance will pay a total premium of $525. But the benefits of the increased deterrence (and lower premium for first party damage insurance) result regardless of whether any individual policyholder buys legal insurance—as long as 50% of individuals subscribe. So every policyholder is likely to subscribe only for the damage insurance since (1) he or she might hope that enough other individual will take out a legal insurance policy; (2) even if not enough individuals subscribe to legal insurance, the damage insurance premium without higher deterrence ($500) is still below the cost of a policy for damage and legal insurance combined ($525). As a result, policyholders enlist only for the damage insurance policy and the deterrent potential of legal insurance remains underexploited.[51] This outcome is disadvantageous to society and to the collective interests of the policyholders in the example. If merely 50% of the potential victims had subscribed to legal insurance, social welfare would have increased: for every victim that spends $75 on legal insurance, *two* potential victims enjoy a reduction of

49. If a third party causes the accident, the victim can sue for damages. If he loses the case, the damage insurance kicks in. In most instances, of course, the victim receives compensation from his insurer while the court case is ongoing.

50. *See supra* Part I.

51. The fact that accident damage insurance is not always complete (due to deductibles, etc.) may provide an incentive to purchase legal insurance.

their expected accident losses of $50 (*75 < 2 x 50*). However, potential victims do not take these positive externalities into account, leading to a socially suboptimal level of legal insurance in society.

C. *Analogies*

An analogy can be made between legal expense insurance and "prosecution societies" in eighteenth-century England.[52] Historically, the English legal system had a criminal system in place that lacked a police force or public prosecutors. In theory, any Englishmen could prosecute any crime, but in practice the victim needed to take upon herself the duties of a private prosecutor. But why would a victim ever prosecute? If a tort victim sues and wins, he or she collects damages. But a private plaintiff in a criminal suit does not typically obtain any financial compensation. Although there were some potential benefits to seeing justice served by way of private prosecution (e.g., vindication, incapacitation of the defendant when a prison term is imposed, etc.), a damage award was generally not available to offset the financial costs of prosecution by the victim.[53] In order to address this issue, societies for the prosecution of felons were formed in the eighteenth century. These societies typically operated within a single town. Each member contributed a small sum once a year.[54] The money was devoted to prosecuting anyone who committed a felony against any member of the society. Interestingly, these societies were able to avoid the free rider problem by publishing the list of members in the local newspaper. This avoided (or at least mitigated) the free rider problem for two reasons. First, because local felons could find out whether someone was a member of a prosecution society in any given town, only paying members obtained the benefits of being a part of the prosecution soci-

52. *See, e.g.*, Craig B. Little & Christopher P. Sheffield, *Frontiers and Criminal Justice: English Private Prosecution Societies and American Vigilantism in the Eighteenth and Nineteenth Centuries*, 48 AM. SOC. REV. 796, 797–98 (1983).

53. One reason to prosecute is the possibility of settling out of court (especially if the defendant has a lot to lose from a conviction). Agreements between the victim and the defendant were, however, illegal in felony prosecutions. Another reason to prosecute was that people who expected to be victims of multiple offenses could establish a reputation for prosecuting and thus buy deterrence. *Id.*

54. *See id.*

ety. In other words, members were able to overcome the public good problem by internalizing the deterrent benefits (i.e., positive externalities) of prosecution societies. Second, by advertising that they were subscribing to an association that furthered the public good, members shamed non-members into joining.[55]

The collective action analogy of legal insurance is also closely related to a key insight from the literature on crime prevention[56]—the distinction between observable and unobservable private precautions.[57] Observable precautions, such as putting iron bars on the windows of a house, generate diversion effects (e.g., a thief who notices iron bars across windows may decide to approach another house). If precautions are unobservable, some potential victims may be tempted to free ride on the precautionary investments made by others. A well-known example involves the installation of Lojack security systems in cars. A Lojack system is a small radio transmitter that is

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55. Joel Mokyr observes:

> The enforcement of property rights through private-order institutions reflects something deep and supremely important about British institutions in the eighteenth century. The culture of respectability and gentility helped solve the standard collective action problems that bedevil the production of public goods. The emergence of a plethora of networks, clubs, friendly societies, academies, and associations created a civil society, in which the private provision of public goods became a reality and created what might be called a *civil economy*.

JOEL MOKYR, THE ENLIGHTENED ECONOMY 381 (2009); *see also* Mark Koyama, *Prosecution Associations in Industrial Revolution England: Private Providers of Public Goods?* 32 (Ctr. for Historical Econ. and Related Research at York, CHERRY Discussion Paper Series) ("[P]rivate prosecution associations not only drew upon, but, in their turn, cultivated, a form of social capital that made the private provision of some forms of public goods feasible.").

56. *See, e.g.*, Ian Ayres & Steven D. Levitt, *Measuring Positive Externalities from Unobservable Victim Precaution: An Empirical Analysis of Lojack*, 113 Q.J. ECON. 43 (1998); Omri Ben-Shahar & Alon Harel, *Blaming the Victim: Optimal Incentives for Private Precautions Against Crime*, 11 J.L. Econ. & Org. 434 (1995); Charles T. Clotfelter, *Private Security and the Public Safety*, 5 J. URB. ECON. 388 (1978); David de Meza & J. R. Gould, *The Social Efficiency of Private Decisions to Enforce Property Rights*, 100 J. POL. ECON. 561 (1992); Keith N. Hylton, *Optimal Law Enforcement and Victim Precaution*, 27 RAND J. ECON. 197 (1996); Steven Shavell, *Individual Precautions to Prevent Theft: Private Versus Socially Optimal Behavior*, 11 INT'L REV. L. & ECON. 123 (1991).

57. *See* Hylton, *supra* note 56; *see also* Shavell, *supra* note 56 (discussing theft prevention as a public good problem).

hidden in one of many possible locations within a car. When a car is reported stolen, the police can activate the transmitter and can track the precise location and movement of the stolen vehicle. If Lojack car systems are very widespread, stealing cars becomes a riskier activity for car thieves. But since criminals cannot ex ante distinguish whether a car has a Lojack system (even if the owner were to put a sticker on the window to signal the presence of a Lojack system), installing Lojack only trivially reduces the likelihood that your own car will be stolen (although it does increase the chance that your car will be retrieved when stolen). Any decrease in the aggregate crime rates due to Lojack is an externality from the perspective of the individual Lojack purchaser. A study by Ayres and Levitt estimates that individuals who install Lojack in their cars obtain less than ten percent of the total social benefits of Lojack. This causes Lojack to be undersupplied in markets.[58] If there are not enough individuals that purchase Lojack, society losses its deterrence benefits. A similar reasoning applies to legal insurance. The relevant analogy is that the positive externality emerges because potential criminals do not know ex ante whether a car has Lojack since a potential criminal cannot recognize this feature ex ante.[59] Since potential criminals do not know ex ante which cars have Lojack, they will not be able to select their victims. The same reasoning applies to potential injurers and victims who are covered by legal insurance: since insurance coverage is not ascertainable prior to negligent action by a wrongdoer, a free riding problem might emerge.

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58. Ayres & Levitt, *supra* note 56. Others have pointed out that a free-rider problem could easily materialize, since would-be thieves will stay away from cars without Lojack out of fear that these cars might have the device. *See* ROBERT E. HALL & MARC LIEBERMAN, MICROECONOMICS: PRINCIPLES AND APPLICATIONS 478–81 (4th ed. 2008). *But see* JOHN R. LOTT, FREEDOMNOMICS: WHY THE FREE MARKET WORKS AND OTHER HALF-BAKED THEORIES DON'T (2007) (recognizing the potential for a free-rider problem but also expressing skepticism about the real effects of Lojack on theft). Note that even if a Lojack owner wanted to signal the presence of Lojack, it would be difficult to do so in a credible manner.

59. It would be different if the crime-deterring technology could be detected ex ante, through, for example, a visible alarm system.

IV.
Supply Side Complications

The relatively weak demand for legal insurance goes hand in hand with supply side complications. Because of the multiplication effect of legal insurance on deterrence, as explained in the previous Part, insurance companies share in the combined benefits of increasing deterrence and reducing accident costs on the basis of legal expense insurance and subrogation. This second order collective action problem helps explain why insurance companies rarely promote legal expense insurance. This incentive issue in the supply of legal insurance is heightened further by several other challenges associated with insurance markets: adverse selection, moral hazard, and the underuse of subrogation.

A. *Adverse Selection and Moral Hazard*

As applied to most insurance settings, providers of legal insurance are faced by the dual challenge of adverse selection and moral hazard. Because insurance premiums are especially valuable to customers that are likely to engage in litigation, there is a risk that legal insurance policies will disproportionally attract litigious subscribers. Because such customers create more costs on average, insurance companies might need to raise premiums over time, which, in turn, makes insurance coverage worthwhile only to the most litigious individuals.[60] Additionally, because insurance coverage reduces the costs of litigation, policyholders' reduced concern with litigation might make them less careful in avoiding incidents or disputes that lead to litigation.[61] Although this issue of moral hazard is recognized more generally with regard to *accident* insurance, the problem is actually even more acute in the context of legal insurance. Even an individual with the most comprehensive accident insurance policy will exercise some care since he or she knows that certain accident losses (severe physical injuries, etc.) cannot be fully undone by way of damage compensation.

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60. George A. Akerlof, *The Market for Lemons: Quality Uncertainty and the Market Mechanism*, 84 Q.J. Econ. 488, 492–93 (1970) (classic paper explaining the adverse selection problem created by information asymmetry in secondhand car markets).

61. Bengt Hölmstrom, *Moral Hazard and Observability*, 10 Bell J. Econ. 74, 74 (1979).

The costs of litigation, by contrast, do not impose such residual concern for a policyholder. Litigation costs can be fully compensated by the insurance company. Due to these adverse selection and moral hazard problems, insurance companies might be less attracted to legal insurance instruments.

B. *The Underuse of Subrogation*

After an insurance company has compensated the expenses of the client, it may seek reimbursement from the person or entity legally responsible for the accident. Such subrogation rights are common in insurance relationships more generally, arising either by contract or by public regulation.[62] If insurance companies effectively use their right of subrogation (or added legal insurance policies as a default to damage insurance), negligent behavior becomes more costly since tortfeasors (or their insurance companies) are more likely to bear the full costs of their actions.

In practice, however, subrogation is underused in insurance markets.[63] Moreover, insurance companies seldom sell damage insurance with legal insurance as a standard (compulsory) addition, unless they are forced to do so by law, as is the case in Sweden.[64]

Upon first sight, insurance companies clearly stand to benefit if they exercise their right of subrogation. What ex-

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62. In most jurisdictions, the common law provides a subrogation right to insurers under property, liability, and some casualty policies. Most health and medical policies expressly include subrogation clauses. *See* JOHN F. DOBBYN, INSURANCE LAW IN A NUTSHELL 385, 389 (4th ed. 1996). On the economics of subrogation generally, see SHAVELL, *supra* note 12, at 255; Alan O. Sykes, *Subrogation and Insolvency*, 30 J. LEGAL STUD. 383 (2001); Thomas S. Ulen, *The View from Abroad: Tort Law and Liability Insurance in the United States*, *in* TORT LAW AND LIABILITY INSURANCE 207 (Gerhard Wagner ed., 2005).

63. Richard Carris and William Bartlett criticize insurers for not asserting their subrogation interests to the fullest extent. *See* Richard Carris & William Bartlett, *Benchmarking Claims Performance*, RISK MGMT., Dec. 1994, at 30, 34. A recent survey finds a subrogation recovery ratio average (gross subrogation dollars recovered divided by paid losses) of merely 8.41%. The survey was commissioned by Praxis Consulting and conducted by the Ward Group. In it, twenty chief financial officers completed surveys about the subrogation policies at their companies. *Focus on Subrogation Missing from Many Firms, Survey Finds*, PROP. CASUALTY 360° (Dec. 9, 2009, 3:32 PM), http://www.property-casualty.com/News/2009/12/Pages/Focus-On-Subrogation-Missing-From-Many-Firms-Survey-Finds.aspx.

64. Regan, *The Swedish Legal Services Policy Remix*, *supra* note 19.

plains the lack of subrogation? The costs of using the legal process to arrive at the correct division of liability costs between insurance companies may explain the lack of subrogation witnessed in insurance markets. Indeed, the expense of apportioning costs across insurance providers has prompted several scholars to advocate the elimination of subrogation rights in different contexts.[65] In many countries, insurers have taken measures to avoid an unnecessarily litigious atmosphere within the industry.[66] Subrogation rights are often exercised on the basis of ex ante agreements (e.g., bulk recoupment, knock for knock, etc.).[67] While these agreements may economize on administrative costs, bulk arrangements reduce the incentives to take care because individual risk differentiation becomes impossible. A complementary explanation for the limited use of subrogation could be that current law restricts insurance subrogation to the amount of benefits that the insurer has paid its subscribers.[68] Since first-party insurance is typically restricted to economic losses,[69] the restrictions preclude an insurer from acquiring control over a substantial por-

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65. *See* FOWLER V. HARPER ET AL., THE LAW OF TORTS (3d ed. 1996); PAUL C. WEILER, MEDICAL MALPRACTICE ON TRIAL 103–04 (1991); Richard A. Epstein, *Coordination of Workers' Compensation Benefits with Tort Damage Awards*, 13 FORUM 464 (1978).

66. Richard Lewis, *Insurers' Agreements Not to Enforce Strict Legal Rights: Bargaining with Government and in the Shadow of the Law*, 48 MOD. L. REV. 275 (1985).

67. Bulk recoupment agreements involve a standard payment of an agreed percentage of all reported claims at a certain amount, usually where the individual amounts involved are relatively small. *See* WERNER PFENNIGSTORF WITH DONALD G. GIFFORD, A COMPARATIVE STUDY OF LIABILITY LAW AND COMPENSATION SCHEMES IN TEN COUNTRIES AND THE UNITED STATES 134–36 (Donald G. Gifford & William M. Richman eds., 1991). For the case of the Netherlands, see Michael G. Faure & Ton Hartlief, *Social Security Versus Tort Law as Instruments to Compensate Personal Injuries: A Dutch Law and Economics Perspective*, *in* THE IMPACT OF SOCIAL SECURITY LAW ON TORT LAW 222 (Ulrich Magnus ed., 2003). In knock for knock arrangements, rights of subrogation are waived. In the United Kingdom, these agreements are made between individual motor insurers. *See* Lewis, *supra* note 66, at 280–81. In the United States, insurance companies often make use of an ex post lay arbitration service.

68. TOM BAKER, INSURANCE LAW AND POLICY 331–32 (2d ed. 2008).

69. W. Kip Viscusi, *Pain and Suffering: Damages in Search of a Sounder Rationale*, 1 MICH. L. & POL'Y REV. 141 (1996).

tion of personal injury claims (non-pecuniary and punitive damages).[70]

Whether the substantial costs of litigation are an acceptable reason to favor the elimination of subrogation or to applaud incentive-dulling agreements between insurers depends on the deterrence benefit of subrogation. From a theoretical viewpoint, many scholars support subrogation because of its positive effect on deterrence.[71] Without subrogation at least part of the damage will not be shifted to the injurer, which reduces his or her incentive to prevent the loss.

Subrogation is usually exercised on the liability insurer, who would optimally differentiate risks and would thus incorporate this increased risk (as a result of subrogation) in the policy conditions of the insured injurer.[72] Of course, a deterrence effect will be doubtful if the exercise of subrogation has no or very little effect on liability insurance premiums. As has been noted by Viscusi, it may be difficult to justify the abolition of subrogation actions in the absence of any empirical support indicating that the loss in controlling risks will be minor.[73] Recent empirical studies confirm the deterrent effect of tort law accountability.[74] Klick and Strattman find that collateral

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70. For example, two thirds of medical malpractice awards in Illinois are non-pecuniary. *See* NEIL VIDMAR, MEDICAL MALPRACTICE AND THE TORT SYSTEM IN ILLINOIS 66 (2005). In an interesting article, Kenneth Reinker and David Rosenberg and have proposed to change the law of insurance subrogation for medical malpractice liability to allow insurers to acquire their insureds' potential malpractice claims without limitation. They argue that this will improve both deterrence and insurance results of medical malpractice liability. Kenneth S. Reinker & David Rosenberg, *Unlimited Subrogation: Improving Medical Malpractice Liability by Allowing Insurers to Take Charge*, 36 J. LEGAL STUD. 261 (2007).

71. *See, e.g.*, SHAVELL, *supra* note 12; Patricia M. Danzon, *Tort Reform and the Role of Government in Private Insurance Markets*, 13 J. LEGAL STUD. 517 (1984); Reinker & Rosenberg, *supra* note 70.

72. Theoretically, this could mean that the exercise of subrogation against a liability insurer would amount to an increase in premiums or the imposition of other policy conditions to prevent accidents. *See* Faure & Hartlief, *supra* note 67.

73. W. Kip Viscusi, *The Dimensions of the Product Liability Crisis*, 20 J. LEGAL STUD. 147, 148 (1991).

74. Under the collateral source rule, the victim of an accident who has received insurance or similar benefits collects full damages from a liable injurer. No reduction is made due to the benefits that have partially or totally eliminated the accident loss. Since the mid-seventies there has been a trend against the collateral source rule; many states introduced a regime of collat-

source reform leads to higher infant mortality rates.[75] Rubin and Shepherd find that the introduction of various forms of set-off regimes had a statistically significant effect on the number of non-motor vehicle accidental deaths.[76] Overall, it is not unreasonable to expect some positive, deterrent effect from subrogation.

Even though the deterrence effects of subrogation might be substantial, insurance companies may not necessarily adopt an aggressive subrogation strategy, however. If an insurance company has a market share of, say, ten percent, then ninety percent of the deterrence benefits would go to other insurance companies (whose premiums do not reflect the costs of subrogation suits). This could lead to a free rider problem that prevents the insurance industry from taking meaningful action. Consider the following example. Suppose that if one of ten existing (e.g., casualty) insurance companies active in a certain region adopts an aggressive subrogation strategy, including the pursuit of many negative expected value suits, the accident rate declines five percent. Consequently, all ten insurance companies could lower their premiums by, for example, $50 (from $250 to $200). Note that this is not an attractive proposition to insurance companies. Doing so would force the insurance company to raise its premium beyond $200. Due to this effort to finance the litigation costs of subrogation, the insurer would suffer a competitive disadvantage.

A similar argument has been made with respect to Lojack prevention technology. Academic commentary offers two opposing perspectives on the question of why most auto insurance companies fail to provide discounts on Lojack devices.[77] According to one viewpoint, Lojack is not advantageous to insurers with a modest market share, since most of the benefit

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eral benefits offset. In this regime, the amount of insurance or like benefits is deducted from the damage payment the injurer is liable for. *See* Fernando Gomez & Jose Penalva, *Insurance and Tort: Coordination Systems and Imperfect Liability Rules*, *in* INTERNALISIERUNGS DES RECHTS UND SEINE ÖKONOMISCHE ANALYSE [Internationalization of the Law and its Economic Analysis] 217–37 (Jochen Bigus et al. eds., 2008).

75. Jonathan Klick & Thomas Stratmann, *Medical Malpractice Reform and Physicians in High-Risk Specialties*, 36 J. LEGAL STUD. 121, 134 (2007).

76. Paul H. Rubin & Joanna M. Shepherd, *Tort Reform and Accidental Deaths*, 50 J.L. & ECON. 221 (2007).

77. In some states discounts are mandated.

will go to their rivals.[78] According to another view, Lojack is probably not very effective. If it were, the free rider problem could be easily solved. For instance, if car manufacturers like Porsche would install Lojack standard on all their cars, thieves would stay away from these cars, and these car manufacturers would reap the benefits.[79] Note however that, even if this argument is correct, it would be hard to find an analogous market solution in the context of legal insurance and tort accident prevention. Overall, these observations suggest that the public good problem of legal insurance markets might be quite pervasive. In Part V, we discuss potential policy options and market interventions.

V.
Policy Options

Whenever litigation costs prevent victims from pursuing valid legal tort claims, the deterrent effect of the tort system is undermined. In this regard, contingency fee arrangements,[80] legal aid, and legal insurance all serve the valuable purpose of facilitating legal claims when individual plaintiffs lack the financial means to pursue a dispute in court. Given the multiplication effect identified in this Article, legal insurance has a unique potential to increase overall accountability and deterrence. In this light, the under-provision of legal insurance policies is a cause of grave concern. In this Part, we discuss a number of policy options that might bolster the adaptation of legal insurance policies.

A. *Status Quo*

Before taking a closer look at the possible solutions for the curious scarcity of active legal insurance policies, it is wise

78. Ian Ayres & Barry Nalebuff, *Stop, Thief!*, Forbes (Jan. 10, 2005), http://www.forbes.com/forbes/2005/0110/088_print.html.

79. When the rate of theft of a particular car model decreases, that model becomes more attractive to consumers because insurance premiums will be lower. *See* Lott, *supra* note 58, at 43–44.

80. *See, e.g.*, Richard Moorhead & Peter Hurst, "Improving Access to Justice:" Contingency Fees: A Study of Their Operation in the United States of America, Civil Justice Council 9–10 (Robert Musgrove ed., 2008) (concluding from a review of the literature that contingency fees may broaden access to justice for multi-party and higher value cases, but also that they may narrow access to justice for lower value cases).

to consider whether or how markets might evolve in the absence of regulatory intervention.[81] Sometimes, insurance industries adjust their practices in reaction to external events. For instance, while disaster insurers did not promote loss control measures for many years, the severe losses caused by Hurricane Andrew urged the insurance industry to take a new perspective on mitigation measures.[82] Likewise, external events may eventually stimulate (first-party) insurers to promote legal expenses insurance more aggressively, since the added deterrence will likely reduce accidents and payouts to insured victims. Note, however, that huge exogenous shocks are not likely with regard to most accidents. An important difference between the damage caused by natural disasters and human actions in accidents relates to the predictability, frequency, and extent of damage caused by the former. The unpredictable nature of disasters can leave insurers with immense losses and take away their opportunity to invest income from premiums. Especially when disasters occur in periods when capital markets provide high returns on investments, the profit margins of insurance companies will decrease substantially. By contrast, the frequency and extent of damage caused by humans (e.g., traffic accidents) is much more predictable. Over the years, these damages may increase, but they often follow quite stable and logical evolutions, giving insurers the possibility to take them into account well in advance.

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81. Any Regulatory Impact Analysis Checklist starts with the advantages and disadvantages of deciding to take no action. *See, e.g.*, OECD, REGULATORY IMPACT ANALYSIS: BEST PRACTICES IN OECD COUNTRIES, 146, 158, 225 (1997), http://www.oecd.org/gov/regulatory-policy/35258828.pdf; *see also* OFFICE OF INFO. & REGULATORY AFFAIRS, REGULATORY IMPACT ANALYSIS: A PRIMER 4 (2011), http://www.whitehouse.gov/sites/default/files/omb/inforeg/regpol/circular-a-4_regulatory-impact-analysis-a-primer.pdf (ordering agencies to "define the baseline" and stating that "the baseline represents the agency's best assessment of what the world would be like absent the action. To specify the baseline, the agency may need to consider a wide range of factors and should incorporate the agency's best forecast of how the world will change in the future, with particular attention to factors that affect the expected benefits and costs of the rule. For example, population growth, economic growth, and the evolution of the relevant markets should all be taken into account.").

82. Howard Kunreuther, *Mitigating Disaster Losses Through Insurance*, 12 J. RISK & UNCERTAINTY 171 (1996).

Still, even if exogenous circumstances could fundamentally alter incentives for the supply of insurance policies, legal insurance coverage will not be widespread unless the demand for policies increases as well. Of course, if the attitudinal change on the supply side causes insurers, for example, to automatically add legal insurance to other insurance policies, any demand side intervention would be unnecessary. But short of that, for instance, if insurers merely put more effort into convincing potential clients to take legal insurance, too many individuals may still decide to remain uninsured. In that case, other policy measures may still be necessary.

B. *Distinguishing Between Different Sources of Market Failure*

This Article has highlighted that the market for legal insurance is plagued by several sources of market failure. We have discussed various challenges on the demand side as well as the supply side.[83]

Consequently, before deciding how to intervene, regulators need to identify what source(s) of market failure(s) is (are) most influential. If the lack of legal insurance coverage is mainly due to individuals' underestimation of the probability that they will be involved in an accident or the chances that they might need to file a claim in court,[84] the most straightforward regulatory approach is to enhance the available information and to correct widespread misperceptions about the costs and risk of litigation. A strand of literature in behavioral science has recently focused on information regulation in a wide range of legal issues, especially involving consumer protection, to correct behavioral anomalies and irrational attitudes towards risk.[85] Empirical evidence suggests however that these behavioral attitudes are quite pervasive and difficult to correct.[86]

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83. *See supra* Parts II & IV.

84. *See supra* Part II. Also, see generally DAN ARIELY, PREDICTABLY IRRATIONAL: THE HIDDEN FORCES THAT SHAPE OUR DECISIONS (2008).

85. *See* Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373, 1375 (2004); RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS (2008).

86. *See, e.g.*, Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1545 (1998); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the*

Before taking action, regulators might want to assess to what extent the demand and supply of legal insurance is caused by the collective action problem identified in this Article. One possible test for the incidence of collective action problems is to examine whether legal insurance coverage is more extended for instances where the injurer can distinguish between victims with and without legal insurance. This might confirm the presence of collective action issues since the other available explanations (e.g., lack of information) do not distinguish between instances where deterrence benefits are shared or where they are fully captured by the individual policyholder. Empirical data from the United Kingdom provide some affirmation that collective action problems help explain the under-provision of legal insurance. Although stand-alone legal insurance policies are not very common in England,[87] a lot of commercial insurance policies are sold on a stand-alone basis.[88] Such policies are the third major component of the English legal insurance market and account for a third of gross premiums. The policies cover typical commercial areas such as contract disputes, data protection, tax, employment, etc. Note that in commercial relationships, insured companies are able to inform their contractual counterparties (prior to disputes) that they have legal expense insurance. Moreover, commercial relationships are often long-term. Once a (potential) dispute arises, it may become known that the victim has legal insurance, and this information will have its effect on the future relations between the parties (and potentially between the victim and other potential injurers when some information flows to them). To summarize, more extensive research might be in order to compare the public good effect of legal insurance markets with other potential factors that reduce the demand for legal expense insurance policies.

C. *Regulatory Approaches*

More direct corrective action might be necessary in order to correct the public good market failure of legal insurance.

Rationality Assumption from Law and Economics, 88 CALIF. L. REV. 1051, 1059 (2000).

87. Stand-alone policies are individual insurance policies that have no other policies included.

88. *See* Kilian, *supra* note 6, at 34.

Various options are available to regulators.[89] First, legislators might consider making legal insurance compulsory or mandating that legal insurance be added to other widespread insurance policies. This approach would solve the collective action issues highlighted above.[90] Also, the pooling of risk on such a large scale would make legal insurance more cost-effective to insurance companies. The effect on insurance policyholders would be more ambiguous. On the one hand, all policyholders would stand to benefit since every subscriber would share in (and contribute to) the increased overall deterrence and the reduction of accident costs. On the other hand, it is important to recognize that this approach takes away the individual autonomy of potential policyholders who might have information or resources that render legal insurance less valuable to them.[91]

Second, regulators might address the lack of subrogation among insurance companies. Avoiding subrogation may assist insurance companies in mitigating administrative costs. Yet, as discussed previously, this attitude also reduces overall accountability and amplifies some of the collective action problems highlighted in this Article. Part of the challenge of mandating subrogation would of course be in the details, especially as it relates to how to structure mandatory subrogation effectively without imposing too high an administrative burden on insurance companies. Of course, if mandatory subrogation causes premiums to go up too, the policy is likely to be counterproductive.[92] Third, policymakers could rely on financial incentives by rewarding individuals who take legal insurance and/or punishing individuals who do not.[93] For example, a tax benefit could be provided to individuals who subscribe to legal insurance.[94] Alternatively, court fees might be raised for

89. *See generally*, Seth J. Chandler, *Insurance Regulation*, *in* 3 ENCYCLOPEDIA OF LAW & ECONOMICS 837 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000).

90. *See supra* Section III.B.

91. *See* Michael G. Faure, *Economic Criteria for Compulsory Insurance*, 31 THE GENEVA PAPERS ON RISK AND INSURANCE 149 (2006).

92. *See supra* Section IV.B.

93. *See* De Geest & Dari-Mattiacci, *supra* note 9 (discussing the relative benefits of applying carrots or sticks).

94. A few European countries, including Belgium, have enacted tax breaks for legal insurance. *See* MICHAEL FAURE ET AL., RESULTAATGERELATEERDE BELONINGSSYSTEMEN VOOR ADVOCATEN: EEN VERGELIJKENDE

plaintiffs who do not have legal insurance. Finally, if none of these regulatory approaches prove viable, another option would be to expand the available system of legal aid to cases that hold the promise of generating substantial deterrence.[95] Since the essence of the problem concerns litigation costs, legal aid assistance can be useful in raising overall accountability while also sustaining the multiplication benefits associated with legal insurance.[96] Of course such approach would encounter the familiar costs involved with subsidized litigation and one would have to be mindful of the problems encountered today with legal aid policies.[97]

CONCLUSION

This Article provides new insights into the various causes and costs of the modest demand and supply of active legal insurance policies. First, we pointed out an overlooked multiplication benefit of legal insurance in the field of tort law. Because legal insurance coverage is non-observable to tort offenders ex ante, such policies affect the average likelihood that a negligent offender will be held accountable. As a result, even if not everyone is insured to bring legal claims, legal insurance increases the overall expected costs of engaging in negligent,

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BESCHRIJVING VAN BELONINGSSYSTEMEN VOOR ADVOCATEN IN EEN AANTAL LANDEN VAN DE EUROPESE UNIE EN HONG KONG [Showing Related Lawyers' Fees: A Comparative Description of Lawyers' Fees in Some Countries in the European Union and Hong Kong] 41 (2006).

95. Gary Bellow, *Legal Aid in the United States*, 14 CLEARINGHOUSE REV. 337, 344–45 (1980); Tom C. Clark, *Changing Times*, 1 HOFSTRA L. REV. 1, 6 (1973) (urging the bar to consider a "prepaid legal insurance similar to hospital and health insurance in the medical field") *cited in* Nora V. Demleitner, *The Challenges to Legal Education in 1973 and 2012: An Introduction to the Anniversary Edition of the Hofstra Law Review*, 40 HOFSTRA L. REV. 639, 648 (2012).

96. Depending on the criteria that would be imposed to receive legal insurance, it is reasonable to assume that potential offenders or tortfeasors would often not be able to distinguish between victims that are eligible to receive legal aid and those that are not.

97. *See, e.g.*, FRANCISCO CABRILLO & SEAN FITZPATRICK, THE ECONOMICS OF COURTS AND LITIGATION 138–44 (2008); John Flood & Avis Whyte, *What's Wrong with Legal Aid? Lessons from Outside the UK,* 25 CIV. JUST. Q. 80 (2006) (arguing that legal aid has to be viewed in tandem with the provision of welfare services); Charles S. Potts, *Right to Counsel in Criminal Cases: Legal Aid or Public Defender*, 28 TEX. L. REV. 491 (1950). See also, on the efficacy of public defenders, LISA J. MCINTYRE, PUBLIC DEFENDER: THE PRACTICE OF LAW IN THE SHADOWS OF REPUTE (1987).

harmful behavior. Second, we showed that the potential of legal insurance remains unexploited due to a host of collective action issues among policyholders and the mixed incentives within insurance industries. Individual policyholders do not capture the full deterrence benefits of their individual subscriptions, while insurance companies may have incentives to promote other insurance instruments. Third, the potential policy options discussed in this Article, ranging from promoting policies to more coercive approaches such as mandatory subrogation and compulsory insurance, could help address these issues and bolster the deterrent effect of the tort system.