



Financially-constrained lawyers: An economic theory of legal disputes [☆]



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ABSTRACT

Financial constraints reduce the lawyer's ability to file lawsuits and bring cases to trial. As a result, access to justice for victims, pretrial bargaining, and potential injurers' precaution might be affected. We study civil litigation using a model that allows for asymmetric information, financially-constrained lawyers, third-party lawyer lending, and a continuum of plaintiff's types. We contribute to the economic analysis of law by generalizing seminal models of litigation (Bebchuk, 1984, 1988; Katz, 1990), offering the first formal definition of access to justice, and presenting comprehensive social welfare analysis of relevant public policy. We provide complete equilibrium characterization and identify necessary conditions for the existence of the mixed- and pure-strategy PBE. Access to justice is denied to some victims under the mixed-strategy equilibrium. We then study the social welfare effects of policies aimed at relaxing lawyers' financial constraints, and identify a necessary and sufficient condition for a welfare-enhancing effect.

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1. Introduction

The U.S. tort system provides \$172 billion in gross compensation to plaintiffs each year. Litigation expenses, which are generally covered by personal injury lawyers on behalf of their clients, represent \$5.2 billion of this compensation (Engstrom, 2014). The average cost of taking a medical malpractice claim to trial is \$97,000 (Shepherd, 2014). Expenses on expert wit-

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nesses in the \$50,000–\$100,000 range are not uncommon (Trautner, 2009). As cases become more complex and hence, more expensive, lawyers might experience financial constraints (Engstrom, 2014; Garber, 2010). Financial constraints weaken the lawyers' ability to file lawsuits and bring cases to trial. As a result, access to justice for victims is compromised. Importantly, by affecting the pool of filed cases, lawyers' financial constraints might also influence pretrial bargaining outcomes and potential injurers' precaution. Hence, a comprehensive analysis of civil litigation should consider the financial constraints that lawyers face. Policy debate, however, has been centered only on the effects of lawyers' financial constraints on access to justice. Previous theoretical work on legal disputes has simply abstracted from lawyers' financial constraints. Our paper aims to fill these gaps. We present the first strategic model of civil litigation in an environment characterized by asymmetric information, financially-constrained lawyers, and a continuum of plaintiff's types. Our framework generalizes seminal economic models of litigation (Bebchuk, 1984, 1988; Katz, 1990).

Traditionally, financially-constrained lawyers have relied on fellow lawyers' contributions and bank loans. In the late 1990s, a third-party lawyer's lending industry emerged.¹ Lawyer lenders such as *Counsel Financial*, among others, started funding activities. These lawyer lending institutions specialize in providing recourse loans (non-contingent loans) to cover the expenses associated with particular legal cases (Garber, 2010). According to legal commentators, “[R]ecourse lawyer lending ... is making a significant mark ... [and has] remarkable potential for future growth” (Engstrom, 2014; p. 397).² In contrast to traditional banks, these lenders do not require lawyers' personal assets as collaterals. Instead, the loans are secured by the law firm's assets, including future fees (Garber, 2010).³ The loans involve significantly larger sums and the interest charged is higher than the traditional bank's interest (around 15–20 percent per year). Our theoretical framework also captures the role of the lawyer lending industry on legal disputes.

We model the interaction between a defendant, a plaintiff, and a plaintiff's lawyer as a sequential game of incomplete information. Our framework allows for asymmetric information, financially-constrained lawyers, third-party lawyer lending, and a continuum of plaintiff's types. The source of information asymmetry is the damage level of the plaintiff's case, which is unknown by the defendant. Our original framework depicts legal disputes from cradle to grave. Specifically, our model allows for endogenous care-taking (precaution), endogenous filing, and endogenous out-of-court settlement decisions. We model the lawyers' financial constraints by incorporating real-world characteristics of the third-party lawyer lending industry. We present the first formal definition of “Access to Justice” and incorporate this concept in the social welfare analysis of relevant public policy.

We provide complete characterization of the two mutually-exclusive perfect Bayesian equilibria (PBE): Mixed- and pure-strategy equilibria. In the mixed-strategy equilibrium, a lawyer with a low-damage case mixes between accepting the case and filing a lawsuit and not accepting the case, and a lawyer with a high-damage case always accepts the case and files a lawsuit; the defendant mixes between making a zero offer and a positive offer. In the pure-strategy equilibrium, lawyers with all types of cases always accept the cases and file lawsuits; and, the defendant always makes a positive offer. Across equilibria, accidents and pre-trial bargaining disagreement are observed. Access to justice is denied to some victims only under the mixed-strategy equilibrium.

We identify necessary conditions for the existence of each PBE. In particular, our analysis demonstrates that the pure-strategy equilibrium arises in a state of the world characterized by lawyers facing mild financial constraints. In contrast, the mixed-strategy equilibrium arises in a state of the world characterized by lawyers facing strong financial constraints. The intuition is as follows. When the level of lawyers' financial constraints is high, then low-damage plaintiffs (i.e., plaintiffs with cases that cannot proceed to trial due to the limited financial resources of their lawyers and/or high litigation costs) are relatively common. The defendant will reduce his expected litigation loss by mixing between a zero offer and a positive offer (instead of making a unique positive offer) because low-damage plaintiffs who receive a zero offer will drop their cases. In contrast, a unique positive offer will be accepted by all low-damage plaintiffs.

We then use our model to study the effects of policies aimed at relaxing lawyers' financial constraints by lowering the costs associated with legal disputes. The interest charged to lawyers by third party lenders and the costs associated with expert witnesses' fees hired by plaintiff's lawyers are examples of such costs.⁴ Given that these policies do not affect equilibrium strategies and outcomes under the pure-strategy PBE, we focus our analysis on the mixed-strategy PBE. Our findings

¹ The third-party litigation funding industry, and the demand for these services by plaintiffs' lawyers and clients, have been amply debated by policy analysts (see for instance the RAND Institute for Civil Justice policy reports by Garber, 2010, and McGovern et al., 2010), studied by legal scholars (see for instance, Molot, 2010, 2009; Rodak, 2006; Steinitz, 2012; and the fifteen articles included in the *DePaul Law Review* symposium volume on litigation and law firm finance, 2014 (see Landsman et al., 2014, in the References section)), and discussed in the media (see for instance, *The Economist*, April 6th 2013; the article by Glater published at *The New York Times*, June 3 2009 (Glater, 2009); the article by Frankel published at *The American Lawyer*, February 13 2006 (Frankel, 2006); and, the article by Carter published at *The American Bar Association's ABA Journal*, October 2004 (Carter, 2004)). However, there are no previous formal models of civil litigation involving financially-constrained lawyers and lawyer's lending institutions.

² Due to the absence of a central repository of data, it is impossible to estimate the exact amount of loans associated with the lawyer lending industry. Engstrom (2014) provides some evidence of the scope of the industry. An important lawyer lender, “*Counsel Financial*, apparently had ‘more than \$200 million’ in loans outstanding as of 2010” (p. 397). Lawyer lenders operate in almost all U.S. states. For instance, *Advocate Capital* funds law firms in forty states. Public records for the state of New York indicate that 250 law firms borrowed from lawyer lending providers during the period 2000–2010.

³ Loans are secured by the estimated value of a firm's total portfolio of cases. Lenders generally require access to the firm's entire docket of cases and assets.

⁴ Policies devoted to strengthening competition in the lawyer lending industry might reduce the costs of third-party loans. Similarly, policies designed to increase efficiency of legal procedures and reduce unpredictability of the legal system by capping punitive damages (Landeo et al., 2007b) might lower the plaintiffs' costs associated with litigation.

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