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## The Interplay between Public and Private Enforcement in European Private Law: Law and Economics Perspective

FRANZISKA WEBER & MICHAEL FAURE\*

**Abstract:** European private law is enforced by different mechanisms and tools that vary between sectors and countries. Some countries, like Germany, may have a strong private law enforcement tradition. In others, such as Scandinavian countries, public law has historically been prevalent. Some countries may be more prone to criminal law enforcement than others. These differing traditions impose a particular challenge on the European legislator that occasionally legislates with the goal of harmonizing law enforcement throughout Europe. From an economic perspective, the threat of enforcement is regarded as guiding people's behaviour or, more particularly, providing incentives to obey the law. In this exercise, different mechanisms vary in their suitability. This article focuses on three mechanisms – private, administrative, and criminal law enforcement – and displays their economic strengths and weaknesses. Ultimately, different mechanisms need to interact to provide an appropriate enforcement response. These mixes will, furthermore, look differently depending on the country in question. This article will first set out the goals and incentives of the different law enforcement models and of the stakeholders involved. It then analyses how these parameters relate to the traditional choice between public and private law enforcement. The British financial sector is sketched as one of the few examples where a 'hybrid' enforcement mechanism that shows elements of both private and public laws is used.

**Zusammenfassung:** Die Durchsetzung des Europäischen Privatrechts geschieht je nach Sektor und Land auf ganz unterschiedliche Weise. Einige Länder, wie beispielsweise Deutschland, haben eine privatrechtliche Tradition in der Rechtsdurchsetzung. Die skandinavischen Länder haben ihrerseits eine stark öffentlich-rechtlich geprägte Rechtsdurchsetzung. Die strafrechtliche Dimension ist in den Ländern wiederum unterschiedlich stark gegeben. Diese unterschiedlichen, gewachsenen Traditionen bilden eine besondere Herausforderung für Harmonisierungsvorhaben des Europäischen Gesetzgebers. Aus ökonomischer Sicht ist die Rechtsdurchsetzung bedeutsam zur Steuerung individuellen Verhaltens. Funktionierende Rechtsdurchsetzung gibt Anreize zu rechtskonformen Verhalten. Verschiedene Rechtsdurchsetzungsmechanismen variieren dabei in ihrer Wirkungsweise. Im vorliegenden Aufsatz werden drei Mechanismen – privatrechtliche, verwaltungsrechtliche und strafrechtliche Rechtsdurchsetzung – behandelt und ihre Stärken und Schwächen aus ökonomischer Sicht dargestellt. Für eine gut

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funktionierende Rechtsdurchsetzung müssen diese Mechanismen miteinander verzahnt und landesspezifische Strukturen bedacht werden. Dieser Aufsatz stellt zunächst die Ziele und Anreizstrukturen verschiedener Rechtsdurchsetzungsmechanismen und der beteiligten Akteure dar. Daraus lassen sich Empfehlungen für die Verwendung der verschiedenen Mechanismen ableiten. Der Aufsatz schließt mit einem Beispiel aus dem britischen Finanzsektor, welches sowohl privatrechtliche als auch öffentlich-rechtliche Elemente miteinander vereint.

## 1. Introduction<sup>1</sup>

What if rights shape up as meaningless because a working enforcement system is lacking? European private law is enforced by different mechanisms and tools that vary between sectors and countries. Some countries, like Germany, may have a strong private law enforcement tradition. In others, such as Scandinavian countries, public law has historically been prevalent. Some countries may be more prone to criminal law enforcement than others. These differing traditions impose a particular challenge on the European legislator that occasionally legislates with the goal of harmonizing law enforcement throughout Europe. The aim of this article is neither to take a historical approach nor to set out existing systems in detail but to provide one specific perspective on law enforcement: the economic analysis of law. Studying the enforcement of private law from this angle will enable us to critically assess current legal solutions in this area.

From an economic perspective, the threat of enforcement is regarded as guiding people's behaviour or, more particularly, providing incentives to obey the law. The interplay between substantive laws and their enforcement forms the incentives and deterrents that induce law-abiding behaviour.<sup>2</sup> Within this setting, different law enforcement mechanisms can be, and have been, assessed.<sup>3</sup> This article will remain to a large extent on an abstract level to facilitate its application to different legal areas.

In this article, we wish to focus on classical private and classical public law enforcement – i.e., individual enforcement via the civil court, an administrative agency, and the criminal court. Economic analysis of law enforcement has shown

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- 1 We wish to thank the participants of the International conference 'Public and Private Enforcement of European Private Law: Perspectives and Challenges' that took place at the University of Groningen on 25 Apr. 2014 for their valuable comments.
  - 2 See C.G. VELJANOVSKI, 'The Economics of Regulatory Enforcement', in *Enforcing Regulation*, eds K. Hawkins & J.M. Thomas (Boston: Kluwer-Nijhoff Publishing 1984), pp (171-191) 171.
  - 3 See R.J. VAN DEN BERGH, 'Should Consumer Protection Law Be Publicly Enforced?', in *Collective Enforcement of Consumer Law*, eds W.H. Van Boom & M.B.M. Loos (Groningen: Europa Law Publishing 2007), pp 179-203; F. WEBER, *The Law and Economics of Enforcing European Consumer Law – A Comparative Analysis of Package Travel and Misleading Advertising* (Markets and the Law Series, United Kingdom: Ashgate-Gower-Lund Humphries 2014); F. WEBER, 'Law and Economics of Self-Regulation in Advertising', 1. *euwr (Journal of European Consumer and Market Law)* 2014, pp 5-16.

that both dimensions entail strengths and weaknesses, reflected in the costs and benefits that they entail for society. The challenge is therefore to design a mix of public and private enforcement that draws upon their comparative advantages.<sup>4</sup> In reality, such a mix may be more complex and envisage a role for various forms of group litigation, alternative dispute resolution, and self-regulation depending on the case study and country in question, as also the contributions in this special volume show. This article will first develop a model of law enforcement by (1) sketching the goals and incentives of the different law enforcement models and of the stakeholders involved, (2) analysing how these parameters relate to the traditional choice between public and private law enforcement, (3) arguing that the crucial question is whether it is possible to look for smart mixes, making optimal use of the complementarities between public and private law enforcement, and (4) illustrating that some combinations are only rarely used but could be further developed as is shown in an interesting case of the British financial sector. Section 6 concludes the article.

## 2. A Model of Law Enforcement

The literature has identified four crucial parameters of law enforcement:<sup>5</sup> (1) the allocation of enforcement powers between various mechanisms, (2) the sanction (injunction, administrative fine, criminal fine), (3) the timing of the intervention (*ex ante* monitoring and/or *ex post* enforcement) and (4) the governmental level – either centralized or decentralized – to accommodate enforcement powers. The four parameters are equally important<sup>6</sup> and closely interlinked. This article deals primarily with the first parameter – the allocation of powers to private or public enforcement; however, the findings on the sanctions and the timing of the intervention are discussed to the extent that they are instrumental to assessing the adequate enforcement mechanism.

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- 4 Also called the ‘optimal mix of public and private enforcement’. See R.J. VAN DEN BERGH & L.T. VISSCHER, ‘The Preventive Function of Collective Actions for Damages in Consumer Law’, 1. *ELR (Erasmus Law Review)* 2008, pp 5-30; F. CAFAGGI & H.-W. MICKLITZ, *New Frontiers of Consumer Protection – The Interplay between Private and Public Enforcement* (Antwerp/Oxford/Portland: Intersentia 2009), p 38; C. HODGES, ‘Objectives, Mechanisms and Policy Choices in Collective Enforcement and Redress’, in *Mass Justice*, eds J. Steele & W.H. Van Boom (Cheltenham, UK: Edward Elgar 2011), pp (101-117) 108; F. WEBER, *Enforcing European Consumer Law*.
- 5 See S. SHAVELL, ‘The Optimal Structure of Law Enforcement’, 36. *JLE (Journal of Law and Economics)* 1993, p (255) 257; S. SHAVELL, ‘Liability for Harm versus Regulation of Safety’, 13. *JLS (Journal of Legal Studies)* 1984, p (357) 357 regarding the first three parameters.
- 6 See R.J. VAN DEN BERGH, in: *Collective Enforcement of Consumer Law*, p (182) 202; R.J. VAN DEN BERGH & L.T. VISSCHER, ‘Optimal Enforcement of Safety Law’, in *Mitigating Risk in the Context of Safety and Security. How Relevant Is a Rational Approach?*, ed. R.V. de Mulder (Rotterdam: Erasmus University 2008), pp (29-62) 33.

## 2.1. Goals and Players

Law enforcement imposes the content of substantive laws upon individuals.<sup>7</sup> From a legal point of view, procedural law is regarded as having a serving function to substantive law (e.g., it may provide litigants with compensation).<sup>8</sup> As previously stated, the economic approach is being followed in this article. Hence, the established goal is to create incentives to comply with the law.<sup>9</sup> Law and economics assess enforcement efforts primarily with a view to their deterrent effects. In the deterrence framework, expected liability matters to the potential wrongdoer *ex ante*, that is, before a wrong is committed.<sup>10</sup> This approach stems from criminal law enforcement and is meanwhile applied more broadly as a benchmark allowing a systematic answer regarding the structure of an enforcement response.<sup>11</sup> The underlying assumption of this model is that (potential) wrongdoers are rational utility maximizers and, therefore, weigh possible benefits against the costs of their behaviour. It is assumed that only if the costs of committing a wrong outweigh the benefits, a rational individual will comply with the law.<sup>12</sup> Like anyone else, they respond to incentives; how these interdepend on the law enforcement response chosen, i.e., when potential wrongdoers will effectively be deterred, will be elaborated upon. Factors that influence the cost side of the wrongdoer are the magnitude of the sanction and the probabilities of detection and conviction.

This article concentrates on three types of law enforcement:

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- 7 Here, the term enforcement is broader than simply the notion of enforcing a title obtained in court but includes it.
  - 8 I.N. TZANKOVA & M.A. GRAMATIKOV, 'A Critical Note on Two EU Principles: A Proceduralist View on the Draft CFR', in *The Foundations of European Private Law*, eds R. Brownsword et al. (Oxford: Hart Publishing 2011).
  - 9 See A.I. OGUS, 'Enforcing Regulation: Do We Need the Criminal Law?', in *New Perspectives on Economic Crime*, eds H. Sjörgen & G. Skogh (Cheltenham, UK; Northampton, MA, USA: Edward Elgar 2004), pp (42-56) 46.
  - 10 See S. SHAVELL, *Foundations of Economic Analysis of Law* (Cambridge, Massachusetts: The Belknap Press of Harvard University Press 2004), p 515. This reflects the concept of general as opposed to individual deterrence, which means that an individual wrongdoer who has already committed a wrong is deterred in the future.
  - 11 Becker's model is the most often cited; see G. BECKER, 'Crime and Punishment: An Economic Approach', 76. *JPE (Journal of Political Economy)* 1968, pp 169-217. H.-B. SCHÄFER, 'The Bundling of Similar Interests in Litigation. The Incentives for Class Action and Legal Actions taken by Associations', 9.3. *EJLE* 2000, pp (183-213) 184.
  - 12 Note that for this article we only address the external costs (such as fines and damage payments) that would induce compliance. However, there can be other elements than the external legal rules that may induce behaviour as well, such as social norms as well as intrinsic motivation.

- (1) The understanding of 'private law enforcement' in the European context is rather straightforward. At the civil court,<sup>13</sup> standing is granted to individuals (under special circumstances), to lawyers, and to other representatives. They may incur litigation fees to differing extents – also depending on the cost rule in place. Importantly, the principle of party presentation is prevalent rather than judicial investigations.
- (2) 'Administrative enforcement' is performed by an agency that can carry out monitoring and has some investigative powers. The agency may decide the case, refer the case to a court, or even defend the case in a court. Actions can be triggered by reporting or carried out on an own motion. Those authorities have a number of investigative and monitoring powers and can impose various sanctions but usually do not grant compensation.<sup>14</sup> In this article, we look at an authority's regulatory capacity to enforce substantive rules of conduct set out by European private law or their capacity to intervene, e.g., against wrongdoing by traders. Usually, if an individual such as a consumer addressed such an entity, no fees would be incurred.
- (3) The public prosecutor is central to the functioning of the criminal process.<sup>15</sup> Once a crime is reported, an investigation is initiated (with the help of the police). The prosecution brings the case as the plaintiff, and the criminal court makes the judgment.<sup>16</sup> Wide investigative powers exist, as well as a wide variety of sanctions; procedures may even allow for dealing with compensation claims. Again, the procedure basically does not entail litigation costs for the individual, who only reported the crime.

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13 By a civil court, we refer in this case to a court where individuals (or groups, depending on the legal system) can bring an individual claim, based on private law, seeking compensation for a loss or other forms of redress. Hence, a civil court in this meaning could also be present in a common law country.

14 Similarly characterized in F. CAFAGGI & H.-W. MICKLITZ, *New Frontiers*, p 406.

15 See J. HODGSON & A. ROBERTS, 'Criminal Process and Prosecution', in *The Oxford Handbook of Empirical Legal Research*, eds P. Cane & H.M. Kritzer (Oxford: Oxford University Press 2010), pp (64-93) 80, who provide an overview of empirical work carried out regarding the role of public prosecutors, in particular addressing their independence.

16 Although the public prosecutor is undoubtedly the central figure in bringing criminal charges in most European legal systems, the prosecutor does not, in all legal systems, have a monopoly position. In some legal systems (such as France), victims may as a 'civil party' bring public charges directly to the criminal court; in the common law countries (especially in the United Kingdom), the crown prosecution service does not have a monopoly and both private parties as well as other public agencies can start a prosecution.

## 2.2. *Incentives and Deterrents at Play*

Several economic criteria have been identified in law and economics literature on law enforcement that determine the strengths and weaknesses of different enforcement mechanisms focusing on the incentives of individuals involved in the enforcement process.<sup>17</sup> We will illustrate the trade-offs individual claimants face and those that may be an obstacle in the law enforcement process more generally.<sup>18</sup> This allows inferences regarding the usefulness and desirability – the costs and benefits – of certain enforcement mechanisms in a given scenario with a view to their deterrent effect. In this analysis, the administrative costs that different enforcement responses entail are a decisive factor;<sup>19</sup> however, the term ‘costs’ is used more broadly. A mechanism that takes many wrong decisions is, for instance, very costly for society in terms of its lack of contribution to compliance and deterrence.

### 2.2.1. *Victims’ Perspective*

Society values the enforcement of a certain share of cases. In this section, we illustrate economic factors that help to determine if those cases are actually going to be enforced. Does an enforcement response happen whenever it is desirable and is it disabled whenever it is not desirable? The initiation of enforcement processes often depends on actions by private parties. A rational individual will not act if costs outweigh the benefits, for instance, when harm is very small and the investment to enforce the law is costly.<sup>20</sup> This is the so-called ‘rational apathy’. If harm to the society is large, for example, in a case of small and widespread harm, no enforcement action may be taken because of a divergence between the individual and social incentive to sue.<sup>21</sup> This harms society. On the other hand, there are cases in which instead of the suing party the defendant turns out to be the victim – the victim of a ‘frivolous lawsuit’ or ‘complaint’. Such an action is not based on merits.<sup>22</sup> No societal resources should be spent on such a case; it needs to be filtered out quickly. These phenomena describe the extremes of the pool of potential lawsuits that we need to pay particular attention to. Frivolous actions become particularly worrisome if they are followed by a wrong

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17 See for a systematization F. WEBER, *Enforcing European Consumer Law*.

18 The upcoming analysis will be based on the standard assumption of risk aversion.

19 See G. BECKER, *JPE* 1968, p 171.

20 See R.J. VAN DEN BERGH, in: *Collective Enforcement of Consumer Law*, p 184.

21 See W.M. LANDES & R.A. POSNER, ‘The Private Enforcement of Law’, 4. *JLS* 1975, pp (1–46) 33.

22 See A. RENDA et al., *Making Antitrust Damages Actions More Effective in the EU: Welfare Impact and Potential Scenarios* (Report for the European Commission Contract DG COMP/2006/A3/012, 2007), p 562.



decision. Error costs refer to courts taking mistaken decisions<sup>23</sup> but can be expanded to anyone who decides a legal matter. Error costs can generally be divided into two groups: Error I costs are those that occur when an individual who is guilty might mistakenly be found not liable ('mistaken acquittal').<sup>24</sup> Error II costs, on the other hand, occur if an innocent individual might mistakenly be found liable ('mistaken conviction'). Both cases dilute deterrence.

Another reason causing a victim not to act is the so-called 'free-riding' problem. We can imagine a situation in which many victims suffer from a law infringement but all gain as soon as one of them complains. For each individual, it is beneficial to wait for someone else to do so and then profit from the result.<sup>25</sup> Again, a socially desirable action may not happen. We can see how this is clearly interrelated with the remedy sought.

More generally speaking, the remedy that can be obtained within a given enforcement structure has an important effect on individuals. The possibility of obtaining compensation is an important motivation.<sup>26</sup> In addition, one of the motives for initiating a lawsuit, or reporting to an administrative agency rather than solving the matter privately, is the need to obtain more information (e.g., access to evidence). To start with, there is an information asymmetry at play between claimant and defendant; sometimes it may even concern the identity of the wrongdoer. Different enforcement solutions need to be assessed to the degree that they are able to generate certain information (e.g., the police can track down a criminal; which information can a lawyer access?).

### 2.2.2. *Incentives of the Stakeholders in the Enforcement Process*

Our first concern was the effect that a law enforcement body's design has on the incentives of individuals whose actions are necessary in initiating a law enforcement response. We have already seen how they depend on 'what the enforcement body has to offer' and 'at what price'. At the same time, we need to ensure that different enforcers perform their tasks as desired. Possible deviations from desired behaviour are primarily discussed under the heading of capture and principal agent situations: Capture is an incentive problem, meaning the exertion of influence on public administration that leads to public officials pursuing, e.g.,

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23 See R.A. POSNER, 'An Economic Approach to Legal Procedure and Judicial Administration', in *The Economic Structure of the Law: The Collected Economic Essays of Richard A. Posner*, ed. F. Parisi (United Kingdom: Edward Elgar Cheltenham 2000), pp (290-349) 291. He refers to system costs as 'direct costs' for operating the legal dispute-resolution machinery.

24 See M. POLINSKY & S. SHAVELL, 'The Theory of Public Enforcement of Law', *NBER Working Paper 11780* (2005), p 36.

25 See R.J. VAN DEN BERGH & L.T. VISSCHER, in: *Mitigating Risk*, p 14; W.M. LANDES & R.A. POSNER, *JLS* 1975, p 29.

26 See S. SHAVELL, *JLE* 1993, p 267: Other incentives for an individual are the desire to avoid future harm, the retributive motive, and possibly a fear of reprisal.



industry interests.<sup>27</sup> This concept can be expanded to other enforcers. To what extent does a structure invite such a type of behaviour?

A weakness inherent in the client-lawyer relationship is that agency problems may occur between them.<sup>28</sup> Generally, in these relationships, the client (principal) cannot fully control the quality of the lawyer's (agent's) performance.<sup>29</sup> The basis for any principal-agent problem is an information asymmetry between two parties,<sup>30</sup> which can lead to moral hazard.<sup>31</sup> The agent uses the principal's inability to assess the value of the steps the agent takes. His motivation may be personal interest; for example, a lawyer may seek to obtain the highest remuneration rather than the best outcome for the client. As the lawyer may be a crucial player in the enforcement process, this issue may be severe. It is aggravated as soon as a lawyer or other representative speaks for a whole group that will, consequently, face even more difficulties in monitoring this agent.

In essence, it is crucial to look at the victims' incentives in terms of being potential initiators of claims and the extent to which enforcers will carry out their delegated tasks.

### 3. Traditional Public versus Private Law Enforcement

How do the different enforcement mechanisms, that we introduced,<sup>32</sup> score when assessed against these economic criteria?

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- 27 See A.I. OGUS, *Regulation: Legal Form and Economic Theory* (Oxford: Clarendon Press 1994), p 57; C. HOOD, H. ROTHSTEIN & R. BALDWIN, *The Government of Risk: Understanding Risk Regulation Regimes* (New York: Oxford University Press 2001), p 112; N. GAROUPA & F. GOMEZ-POMAR, 'Punish Once or Punish Twice: A Theory of the Use of Criminal Sanctions in Addition to Regulatory Penalties', *Harvard Law School John M. Olin Center for Law, Economics and Business Discussion Paper Series. Paper 308* (2000), pp (1-30) 5 and 17; J.Q. WILSON, *Bureaucracy – What Government Agencies Do and Why They Do It* (New York: Basic Books A Division of HarperCollins Publishers 1989).
- 28 See S. SHAVELL, 'The Fundamental Divergence between the Private and the Social Motive to Use the Legal System', 16. *JLS* 1997, pp (575-612) 599.
- 29 See S. SHAVELL, 'Risk Sharing and Incentives in the Principal and Agent Relationship', *Bell Journal of Economics, The RAND Corporation 10.1* 1979, pp 55-73; H. COLLINS, *Regulating Contracts* (New York: Oxford University Press 1999), p 236.
- 30 See K.-G. LÖFGREN, T. PERSSON & J.W. WEIBULL, 'Markets with Asymmetric Information: The Contributions of George Akerlof, Michael Spence and Joseph Stiglitz', 104.2. *Scandinavian Journal of Economics* 2002, pp 195-211.
- 31 See C. KESER & M. WILLINGER, 'Experiments on Moral Hazard and Incentives: Reciprocity and Surplus-Sharing', in *The Economics of Contracts Theories and Applications*, eds E. Brousseau & J.-M. Glachant (Cambridge: Cambridge University Press, 2002), pp 293-312, in which a whole section is devoted to the principal-agent problem and moral hazard. Moral hazard arises because an individual does not internalize the full consequences of actions and, therefore, has a tendency to act less carefully than otherwise.
- 32 More particularly private law and public law (administrative and criminal laws) enforcement, as introduced in s. 2.1.

### 3.1. *Victim's Incentives*

#### 3.1.1. *Rational Apathy versus Frivolous Lawsuits*

In a civil procedure primarily, court and lawyer's fees are incurred. Depending on the cost rule (e.g., loser-pays rule), the parties have to bear them to differing extents. Both parameters will determine the cost side in an individual's calculation. The individual will weigh them up against possible benefits from initiating a legal action. Needless to say a substantial damage payment will impact this calculation differently than a minor compensation payment. In one case, an individual will initiate a lawsuit, whereas in the other case it is much more uncertain, and rational apathy may come into play. The severity of the 'rational apathy' problem primarily depends on litigation fees (for instance, reduced by small claims courts or alternative dispute resolution tools), allocation rules for civil procedure costs, the confidence of winning, and the remedy sought. The danger of under-enforcement must be considered, particularly in cases of small and widespread harm.<sup>33</sup> To remedy this disincentive, the enforcement mechanism may offer options for risk sharing (e.g., legal aid or legal insurance).<sup>34</sup> One can consider how far procedures can be joined together to reduce the individual's costs. In some countries, a public figure may even represent a single individual under certain conditions in court and can assume the procedural costs.<sup>35</sup> Thus, these are ways to improve the risk allocation, with the state or the defendant assuming part of the risk.

Regarding the potential for frivolous lawsuits in general, it can be assumed that a single lawsuit will not generate huge reputational harm. Things might look different for lawsuits involving two competitors<sup>36</sup> or if claims were bundled.<sup>37</sup> This danger depends on the potential gains that can be achieved. It can be countered by systems filtering out such cases quickly.

With widely dispersed harm, a case can be made for public enforcement (or also some form of group litigation<sup>38</sup>) to uphold the threat of a lawsuit, as the

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33 See M. POLINSKY & S. SHAVELL, *NBER Working Paper 11780*, p 21; S. SHAVELL, *JLS* 1997, p 577.

34 See S. SHAVELL, *JLS* 1997, p 576; L.T. VISSCHER & T. SCHEPENS, 'A Law and Economics Approach to Cost Shifting, Fee Arrangements and Legal Expense Insurance', in *New Trends in Financing Civil Litigation in Europe: A Legal, Empirical and Economic Analysis*, eds M.L. Tuil & L.T. Visscher (Cheltenham: Edward Elgar 2010), pp 7-32.

35 There is, for instance, a consumer Ombudsman in the Scandinavian countries. In a way, this is like a legal aid provision.

36 Compare the situation of competitors in antitrust cases, A. RENDA et al. *Making Antitrust Damages*, p 563.

37 See H.-B. SCHÄFER, *EJLE*, p (183) 184.

38 Part of the analysis of public law enforcement may likewise be true for strengths and weaknesses of group litigation that could not be dealt with in detail in the context of this article.

individual clearly does not have an incentive to sue.<sup>39</sup> With administrative law enforcement, as well as with criminal law enforcement, the public as a financer assumes (large parts of) the risks involved in litigation, leading to lower costs to the individual.<sup>40</sup> What are the other effects of these variants of public enforcement?

For administrative law enforcement, one can imagine that a consumer who reports a wrong to a Consumer Authority is not charged any fee. The state is supposedly the best risk bearer because it has numerous possibilities for risk pooling. An agency can act on its own motion and, to some extent, is independent of the rational apathy problems that exist with individuals. Depending on the case, some form of reporting – with potential rational apathy problems – may be necessary to make the authority aware of an infringement.<sup>41</sup> Because many violations may be hidden or can only be detected with high costs and with technical expertise, pro-active *ex ante* monitoring by public authorities may be necessary since a reactive approach would not sufficiently detect violations.<sup>42</sup>

In stark contrast to civil litigation, the benefits for individuals involved in such a procedure usually do not include compensation.<sup>43</sup> This has the potential to reduce the incentive to involve a public agency. Public agencies traditionally have remedies like injunctions, revocation of licences, or fines at their disposition. Where an individual may be mainly interested in damages, incentives in this branch must be designed carefully to induce an individual to report. Then again, there are hardly any costs involved in reporting. For an authority to obtain necessary information, monitoring may be an alternative source of information, as will cooperation with, e.g., consumer advice centres. Frivolous lawsuits seem to be less of an issue within administrative law enforcement, at least in the classical sense, because individuals may at most report a violation without guarantees that a case will be taken up. The public official filters which cases to dismiss and which cases to admit. The challenge effectively becomes to design the process of case selection well, possibly designing some ways of challenging a public official's decision not to admit a case. Within an administrative procedure, the danger of error costs depends on the complexity of the issues to be solved and on the

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39 See S. SHAVELL, *JLS* 1984, p 167.

40 Ultimately, of course, tax payers' money finances the whole system.

41 See M.G. FAURE, in '*Onbegrensde Toezicht?*' *Toezicht op Markt en Mededinging (Justitiële Verkenningen)*, ed. WODC (Den Haag: Boom Juridische Uitgevers 2008), pp (84-104) 100.

42 See M.G. FAURE, A.I. OGUS & N. PHILIPSEN, 'Curbing Consumer Financial Losses: the Economics of Regulatory Enforcement', 31.2. *Law & Policy* 2009, pp 168-170.

43 However, in some cases, the individual can use the outcome of the administrative law enforcement in a subsequent private lawsuit.

resources, expertise, and experience of the public authority.<sup>44</sup> The occurrence of error costs is more likely in administrative enforcement compared with criminal law enforcement, because the decision-making process is less elaborate (see below).<sup>45</sup> Therefore, naming and shaming by public authorities is, for instance, regarded as dangerous. Whereas no compensation can be granted, sanctions like high fines are interesting from the point of view of deterrence of wrongdoing to induce compliance with the law. The investigative powers may increase detection rates.

As mentioned, in criminal law also the state bears a considerable amount of the costs and risks.<sup>46</sup> The mechanism can be set into motion on an own motion, ruling out rational apathy problems; however, private parties are often important in reporting information to the state, the police, public prosecution offices, or courts.<sup>47</sup> In order for criminal law enforcement to be triggered, an ‘initial suspicion’<sup>48</sup> that a crime has occurred must be reported to the police; the public prosecutor then investigates and takes action. If the individual feels that there are no benefits from reporting – notwithstanding the legal obligation to report certain crimes – the individual’s rational apathy may impede reporting. Some may even fear retaliation if they report a crime.<sup>49</sup>

Whereas civil procedural law and the public law option of administrative law were contrasted regarding the possibility of obtaining compensation, criminal law is a special public law enforcement tool: In some jurisdictions, there exists the possibility of being granted damages via the criminal law branch, and this may contribute to the willingness of the party to report. Generally, a victim who joins the prosecution as plaintiff needs a lawyer. Therefore, more costs may be incurred. However, there is not necessarily a statutory requirement to be represented by a lawyer. Legal aid provisions or legal insurances may be utilized and, if found guilty, the accused will have to bear (depending on the legal system) some or all of the costs. Frivolous lawsuits leading to a conviction are unlikely in the criminal law enforcement system due to the high burden of proof; arguably, damage can be inflicted if the initial suspicion is based on wrong arguments.

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44 See R.J. VAN DEN BERGH, in: *Collective Enforcement of Consumer Law*, p 195. See also A.I. OGUS, in: *New Perspectives*, p 44, where he distinguished the burden of proof and procedural safeguards between criminal law and administrative law from high to low.

45 See N. GAROUPA & F. GOMEZ-POMAR, *Harvard Law School John M. Olin Center for Law, Economics and Business Discussion Paper Series. Paper 308*, p 5; M.G. FAURE, A.I. OGUS & N.J. PHILIPSEN, *Law & Policy*, p (161) 176.

46 See Expertentagung, *Wilhelminenberg Gespräche* (2011). Collective actions at a criminal court are discussed in particular because they reduce the individual’s cost risks.

47 See S. SHAVELL, *JLE* 1993, p 260.

48 The term ‘reasonable suspicion’ is used in J. HODGSON & A. ROBERTS, in: *The Oxford Handbook*, p 67.

49 See S. SHAVELL, *JLE* 1993, p 268.

Reputational damage occurs in apprehending someone and it is only secondary that the case may never be prosecuted because the allegations could not be confirmed. In this instance, error costs might already apply if the person is innocent. As already mentioned when contrasting it with administrative law enforcement, error costs can be remedied to a large extent by criminal procedural law, which is more accurate compared with administrative law. Criminal procedural law involves an appeal structure, a standard of proof 'beyond reasonable doubt' and consideration of the mental element.<sup>50</sup> Because of the high standard of proof in criminal law, there is a lower probability of convicting the innocent.<sup>51</sup> Error costs depend on the accuracy of procedural law, and the more accurate the procedure is, the less often errors occur. When errors do occur, the severity of costs to the accused or the victim depends on the severity of the sanctions. Stigma (i.e., damage to a person's reputation), if it is involved in a sanctioning mechanism, leads to higher error costs. Criminal law enforcement typically includes more severe sanctions than administrative law enforcement.<sup>52</sup> High sanctions available in criminal law enforcement are also interesting for deterrence purposes.<sup>53</sup>

### 3.1.2. *Free Riding*

The 'specificity feature' entails<sup>54</sup> that civil courts decide cases with specific claimants and specific circumstances. Therefore, individuals must instigate each of their claims separately.<sup>55</sup> Free riding is not an issue in this situation; however, it may occur in cases of injunctions or reforms resulting from a judgment that provides benefits to people other than the claimant. The allocation of risks to all who profit from a remedy would have to be guaranteed to avoid the risk of

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50 See R. BOWLES, M.G. FAURE & N. GAROUPA, 'The Scope of Criminal Law and Criminal Sanctions: An Economic View and Policy Implications', 35.3. *JLS (Journal of Law and Society)* 2008, p (389) 405; R. GALBIATI & N. GAROUPA, 'Keeping Stigma out of Administrative Law: An Explanation of Consistent Beliefs', 15. *SCER (Supreme Court Economic Review)* 2007, p (273) 274; K.N. HYLTON & V.S. KHANNA, 'Toward an Economic Theory of Pro-Defendant Criminal Procedure', *Discussion Paper No. 318.3* (2001).

51 See R.A. POSNER, in: *The Economic Structure of the Law*, p (201) 410.

52 See R.J. VAN DEN BERGH, in: *Collective Enforcement of Consumer Law*, p 196.

53 See M. POLINSKY & S. SHAVELL, *NBER Working Paper 11780*, p 26. On low probabilities of detection, see also W.M. LANDES & R.A. POSNER, *JLS* 1975, p 36. There is also the possibility of imposing fines that exceed the harm.

54 See W.H. VAN BOOM, *Efficacious Enforcement in Contract and Tort* (Den Haag: Boom Juridische Uitgevers 2006), p 13; W.H. VAN BOOM, 'Effectuerend Handhaven in het Privaatrecht', 16. *NL (Nederlands Juristenblad)* 2007, p (982) 985.

55 See W.H. VAN BOOM, *Efficacious*, p 41; see F. CAFAGGI, 'The Great Transformation. Administrative and Judicial Enforcement in Consumer Protection: A Remedial Perspective', 21. *LCLR (Loyola Consumer Law Review)* 2009, p (496) 522. Coordination between injunctions and other remedies exists more for specific areas than as a general policy in Europe.

inaction due to a free-rider problem. Free riding may be less likely if risks to the individual are reduced. For instance, if an injunction can be achieved at low cost by simply reporting the infringement to a public agency, the individual may be less inclined to wait for someone else to act and act himself. The decisive factors for the free-riding problem seem to be the effect of the remedy and the costs of the procedure. If a competitor reaped benefits from an intervention, the competitor might be inclined to report and/or provide a public authority with information or initiate another type of enforcement action.

It is common to public authorities that the action they take is beneficial for the whole society. If an agency is involved, free riding is rather unlikely because individuals are forced to contribute to the litigation expenses through taxes.<sup>56</sup> However, a discrepancy might exist in terms of who contributes and who profits from an action. Then again, the agency can act on an own motion. The conditions, when this would happen and who could challenge it, however, need to be clear to counter capture problems (see below).

The effect of free riding in criminal court proceedings is doubtful. Other individuals will inevitably profit if a wrongdoer is sent to prison and, therefore, is no longer able to continue wrongful business activities. However, victims need to have an 'interest' in the case in order to report. There is also the option of an own motion; thus, the system is not dependent on a reporting action. Therefore, passivity in reporting cannot lead to a lack of criminal law enforcement under the condition that the criteria for when to prosecute are clearly set out and that the failure to act is challengeable. Victims do not bear the majority of costs of criminal proceedings and the reasoning is similar to that of involving a public agency. If the costs of doing so are low, individuals may report wrongs and crimes despite not expecting any direct or large individual benefits from it. In practice, failure to report certain crimes may be punishable.

### 3.1.3. *Information Asymmetry*

The individual's decision to act will also be influenced by the degree to which potentially existing information asymmetries as to the facts of the case, the evidence, or the nature of the wrongdoer (e.g., the location) can be cured by an enforcement system. In civil litigation, pre-trial discovery may be decisive for the amount of proof that the claimant can generate.<sup>57</sup> However, it is not available in most European legal systems.

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56 See R.J. VAN DEN BERGH, 'Enforcement of Consumer Law by Consumer Associations', in *Essays in the Law and Economics of Regulation – in Honour of Anthony Ogus*, eds M.G. Faure & F.H. Stephen (Antwerpen/Oxford/Portland: Intersentia 2008), pp (279-306) 305.

57 It is said to lead to more costs as well, see C.J. MENKEL-MEADOW & B.G. GARTH, 'Civil Procedure and Courts', in *The Oxford Handbook of Empirical Legal Research*, eds P. Cane & H. M. Kritzer (Oxford: Oxford University Press 2010), pp (679-704) 693.

For many private law scenarios, once an infringement is detected, an individual can be assumed to have the necessary information to initiate a lawsuit.<sup>58</sup> Before a civil court, claimants must provide most of the evidence and may not rely on the inquisition of the judge – the core of the principle of party presentation. Therefore, if the individual misses information, lawsuits may be impeded if lawyers or civil judges cannot generate it either. This may effectively be the case regarding a wrongdoer's identity and location.<sup>59</sup> Often neither the individual, nor the lawyer, nor the judge can generate this information.

If law infringements are difficult to discover, an agency's lower costs of information discovery can be useful.<sup>60</sup> When information becomes highly technical, a public authority might be better equipped to gather it.<sup>61</sup> Technological developments such as information systems (databases) shift the efficiency arguments in favour of the public sector. Economies of scale generally support using the public law system in this context, particularly if duplication of enforcement costs among private parties were to occur.<sup>62</sup> When locating wrongdoers, a public authority may have more powers and the ability to cooperate with other authorities (even increasingly with authorities across borders). Likewise, for instance, tracking online traders (digital investigation) requires certain particular investigative powers that are tools unavailable to individuals.<sup>63</sup> While not all authorities have the same number of powers, there is certainly a

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- 58 See R.J. VAN DEN BERGH, in: *Collective Enforcement of Consumer Law*, p 186, for example, in traffic accidents.
  - 59 See R.J. VAN DEN BERGH, in: *Collective Enforcement of Consumer Law*, p 201; K.J. CSERES, 'Consumer Protection in the European Union', in *Regulation and Economics* (Vol. 9, Encyclopedia of Law and Economics), eds R.J. Van den Bergh & A.M. Paccos (2nd edn, Cheltenham, UK/Northampton, MA, USA: Edward Elgar 2012), pp (163–228) 192; for tort law scenarios, see S. SHAVELL, *JLE* 1993, p 274; the hit-and-run offender is a classical example of an attempt to conceal someone's identity.
  - 60 See for consumer law and competition law: R.J. VAN DEN BERGH, in: *Collective Enforcement of Consumer Law*; a public enforcer has a lower cost of information discovery since it can use the power of the state – such as the threat of jail, the power of the police to conduct searches and seizures of evidence, clandestine electronic surveillance and undercover agents, see I.R. SEGAL & M.D. WHINSTON, 'Public vs. Private Enforcement of Antitrust Law: A Survey', *Stanford Law and Economics Olin Working Paper No. 335* (2006), p 6. They refer to antitrust cases.
  - 61 See S. SHAVELL, *JLE* 1993, p 270; C. HOOD, H. ROTHSTEIN & R. BALDWIN, *The Government of Risk*, p 73.
  - 62 See W.M. LANDES & R.A. POSNER, *JLS* 1975, p 29: An example would be competition authorities that do not only have more resources but also wide investigate powers that an individual could not make use of. In addition, economies of scope can speak in favour of the involvement of a public authority; see M.J. TREBILCOCK, 'Rethinking Consumer Protection Policy', in *International Perspectives on Consumers' Access to Justice*, eds C.E.F. Rickett and T.G.W. Telfer (Cambridge: Cambridge University Press 2003), pp (68–98) 84.
  - 63 Future technological developments might render it indeed worthwhile to equip individuals or their lawyers with wider investigative powers. Low administrative (and other societal) costs might



potential to equip them. The public agency has different tools at its disposal that the individual lacks. Administrative law enforcement allows for continuous information gathering through monitoring or market studies to detect infringements. Certain existing information asymmetries that private law cannot remedy could, to some extent, be outweighed by the involvement of a public agency. These entities may, however, lack private information (if individuals have no incentive to share it), and solutions need to be imagined.<sup>64</sup> The matter boils down to the question of which information is in the hands of whom.

Criminal law enforcement's wide investigative powers, particularly the police force, provide a number of advantages for generating information that the individual may not obtain. They are even wider than the classical investigative powers that an administrative authority has. In particular, where other enforcement systems would be unable to act, criminal law enforcement (the police) is able to locate and apprehend certain wrongdoers and initiate a case. Among the available investigative powers, those pertaining to criminal law go the furthest and include tools to which an individual does not have access. However, resources are crucial to utilize the additional investigative powers. Criminal law typically deals with the cases for which the likelihood of apprehending and convicting offenders is assumed to be low.<sup>65</sup>

An issue related to the information problem to the extent that one is looking for an effective remedy is the need to know what people can be deterred by. This gives us an opportunity to shortly introduce the 'judgment-proof wrongdoer', i.e., an insolvent wrongdoer. As to insolvency, law and economics literature argues that private law generally provides only purely monetary sanctions that cannot sufficiently deter a judgment-proof offender.<sup>66</sup> This is generally true. However, a civil law injunction is different because that prospect can be a powerful deterrent for a trader.<sup>67</sup> In addition, administrative law has primarily monetary sanctions, like fines, in its power. However, sanctions such as

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justify this at some point. For the time being, societal costs are assumed not to outweigh the benefits of equipping every individual with wide investigative powers.

64 See W.H. VAN BOOM & M.B.M. LOOS, 'Effective Enforcement of Consumer Law in Europe: Synchronizing Private, Public, and Collective Mechanisms', *Working Paper Series* (2008), p 16. In competition law, leniency programs are, for instance, regarded as providing private information within public law enforcement structures, see S. KESKE, *Group Litigation in European Competition Law: A Law and Economics Perspective* (Antwerp: Intersentia 2010), p 20; S. SHAVELL, *JLE* 1993, p (259) 267. See on self-reporting: L. KAPLOW & S. SHAVELL, 'Optimal Law Enforcement with Self-Reporting of Behavior', 102.3. *JPE* 1994, pp 583-606.

65 See S. SHAVELL, *JLE* 1993, p 275.

66 See S. SHAVELL, *Foundations*, 2004, pp 473. An insolvent trader cannot be deterred by purely monetary sanctions. In practice, this is where insurances and funds come into play. In contract law, the judgment-proof problem is mitigated, according to S. SHAVELL, *Foundations*, 2004, p 586, as people tend to know about each other.

67 See M.G. FAURE, A.I. OGUS & N.J. PHILIPSEN, *Law & Policy*, p 176.

licence revocation available to a public agency might be effective with regard to a judgment-proof wrongdoer.<sup>68</sup> An important advantage of criminal law enforcement in this respect is that the system's various available sanctions include non-monetary ones, primarily imprisonment, that serve to remedy the issue of a judgment-proof defendant.<sup>69</sup> Imprisonment is essential as a deterrent<sup>70</sup> and is the desirable sanction when the probability of detection and conviction is low and the likelihood of defendants being judgment-proof is high.<sup>71</sup> Another important distinction between criminal law and private law enforcement is that under criminal law attempts to do harm can be sanctioned, whereas under contract and tort law, legal consequences apply only where harm occurs (the breach of a contract or a tort).<sup>72</sup>

### 3.2. *Incentive Structures within the Enforcement Mechanisms*

#### 3.2.1. *Capture*

As the name suggests, public officials work in the public interest. When it comes to assessing public servants' behaviour and predictability, a rather severe issue in a public agency is the risk of capture of officials that leads to under-enforcement.<sup>73</sup> This is more dangerous, the more competences the agency has, and the extent to which welfare can be diluted depends on the importance of the case.<sup>74</sup> Regulation to separate competences either by different entities or different units may be warranted,<sup>75</sup> and the possibility of appeals and reviews (as

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68 See M.J. TREBILCOCK, in: *International Perspectives*, p 84; see M.G. FAURE, A.I. OGUS & N.J. PHILIPSEN, *Law & Policy*, p 178, expand on the issue of licences and how this can possibly have a higher deterrent effect for traders than imprisonment.

69 See R. BOWLES, M.G. FAURE & N. GAROUPA, *JLS* 2008, p 402; S. SHAVELL, 'Criminal Law and the Optimal use of Nonmonetary Sanctions as a Deterrent'. *Colum. L. Rev. (Columbia Law Review)* 1985, p (1231) 1247; S. SHAVELL, *Foundations*, 2004, p 544.

70 See M. POLINSKY & S. SHAVELL, *Economic Analysis of Law* (2005), p 28. However, if a person is old or dying from a disease, imprisonment cannot fulfil its full purpose; see S. SHAVELL, *Foundations*, 2004, p 532. Here, for example, incapacitation measures are necessary and desirable.

71 See R. BOWLES, M.G. FAURE & N. GAROUPA, *JLS* 2008, p 405.

72 See S. SHAVELL, *Foundations*, 2004, p 571.

73 See A.I. OGUS, *Regulation* 1994, p 57.

74 See C. TESAURO & F. RUSSO, 'Unfair Commercial Practices and Misleading and Comparative Advertising: An Analysis of the Harmonization of EU Legislation in View of the Italian Implementation of the Rules', 4.1. *Competition Policy International* 2008, pp 192-222. The Italian authority had not clearly defined its competences, and they were then stipulated in many appeal procedures.

75 See F. CAFAGGI & H.-W. MICKLITZ, *New Frontiers*, p 406: 'In theory the use of public agencies to monitor and directly sanction would seem to be more effective than separating administrative monitoring from judicial enforcement. But especially in relation to cooperative enforcement, when the enforcer has to conclude agreements with the infringer, the resort to an independent

generally given within administrative procedural law) may reduce the occurrence of this risk. Another measure is the case selection procedure and ways to challenge the inaction of the entity.

Because judges (civil and criminal) who impose sanctions are believed to be impartial,<sup>76</sup> the issue of capture at first sight seems less important. Furthermore, adjudication and prosecution/investigation are separate in criminal law enforcement; in other words, the public prosecutor and the courts are independent of each other.<sup>77</sup> Regarding the public prosecutor, capture issues could be present in the selection of cases to pursue.

### 3.2.2. *Principal-Agent Problems*

In civil litigation, the principal-agent problem is certainly aggravated in mass litigation<sup>78</sup> but may also be an issue in an individual case. This issue is immediately mitigated as soon as structures such as small claims procedures emerge, in which individuals who have suffered harm, and defendants, can represent themselves without involving lawyers.

In administrative law enforcement, principal-agent situations may rather occur on the side of the defendant and the defendant's lawyer than on the side of the individual who only reports a wrong.<sup>79</sup> According to definition, a public authority works in the public interest. As mentioned, capture may play. Compared to criminal law, as referred to, procedural safeguards are lower. This may increase the danger of non-accurate decisions.

The principal-agent relationship between the accused and the lawyer is assumed in criminal law enforcement and is characterized by information asymmetries. Likewise, principal-agent issues may occur if the victim joins the procedure as plaintiff with a lawyer.

### 3.3. *Administrative Costs*

Administrative costs are a highly relevant factor in determining model law enforcement.<sup>80</sup> Is private enforcement cheaper to administer than other enforcement schemes?

In the civil court, relevant administrative costs are the time, effort, and legal expenses that private parties bear, as well as the public expenses of

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judiciary may ensure transparency and reduce capture. Thus the higher the use of cooperative enforcement, the more necessary it is to resort to separation between monitoring and enforcement.'

76 See H. COLLINS, *Regulating Contracts*, p 82.

77 See R. BOWLES, M.G. FAURE & N. GAROUPA, *JLS* 2008, p 407.

78 See H.-B. SCHÄFER, *EJLE*, p 191.

79 In appeal procedures, ultimately both parties might involve lawyers.

80 See G. BECKER, *JPE* 1968, p 171.

conducting civil trials (including calculating damage).<sup>81</sup> Few studies that measure these costs accurately exist. Litigation costs of small claims are normally lower than those of large claims.<sup>82</sup> As has been stressed by Shavell, one of the strengths of the private liability system is that its deterrent effect works even when no or very few cases (especially under the negligence rule) are brought. That could hence reduce costs. Safety regulation (enforced through administrative law) works *ex ante* and is not triggered by harm and could therefore potentially lead to high costs.<sup>83</sup> It would depend on how precisely the mechanism is shaped. Costs may be weighted differently. Unlike with private enforcement, the main costs with public enforcement occur in the form of monitoring and detection: particularly, the use of investigative powers.<sup>84</sup> Then again, a public authority is generally not concerned with calculating and distributing damage. Regarding fines, arguments can be made for why fines are comparably less costly to administer than other remedies, particularly fixed fines.<sup>85</sup> Administering the public entity can be more costly if various entities have to be coordinated.

The consensus is that criminal law enforcement involves very high administrative costs because it includes an appeal structure that supports accuracy and avoidance of error costs.<sup>86</sup> Therefore, conviction costs are higher and sanctions, mainly imprisonment, are expensive.<sup>87</sup> Furthermore, additional resources are required when criminal law enforcement considers the mental state of the accused.<sup>88</sup> In addition, and depending on the legal system, compensation must be calculated and distributed.

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81 See for instance S. SHAVELL, *JLS* 1984, p 364.

82 See A.J. DUGGAN, in: *International Perspectives*, p 48.

83 S. SHAVELL, *JLS* 1984, pp 357-374.

84 See D. WITTMAN, 'Prior Regulation versus Post Liability: The Choice between Input and Output Monitoring', 6. *JLS* 1977, pp (193-212) 207; overall little empirical research has been done on regulatory agencies within consumer protection; see S. MEILL, 'Consumer Protection', in *The Oxford Handbook of Empirical Legal Research*, eds P. Cane & H. M. Kritzer (Oxford: Oxford University Press 2010), pp (176-197) 186.

85 See M.G. FAURE, A.I. OGUS & N.J. PHILIPSEN, *Law & Policy*, p 175.

86 See S. SHAVELL, 'Economic Analysis of Litigation and the Legal Process', *NBER Working Papers National Bureau of Economic Research, Inc.* 9697 (2003), p 49.

87 See G. BECKER, *JPE* 1968, p 180. Costs of imprisonment include expenditures for guards, supervisory personnel, buildings, food and so on; A.I. OGUS, in: *New Perspectives*, p 45: 'The costs increase very sharply'. See also M.G. FAURE, A.I. OGUS & N.J. PHILIPSEN, *Law & Policy*, p 167: 'It is clear that some criminal penalties, such as imprisonment, are more expensive to apply than administrative or civil penalties. However, the process costs are also higher: The procedural requirements of criminal liability make it much more costly than administrative and civil procedures'.

88 See R. GALBIATI & N. GAROUPA, *SCER*, p (273) 274; N. GAROUPA & F. GOMEZ-POMAR, *Harvard Law School John M. Olin Center for Law, Economics and Business Discussion Paper Series. Paper 308*, p 4: An administrative agency neglects the mental states of an offender. Overall, it should be

#### 4. Smart Mixes between Private and Public Law Enforcement

Private individuals often litigate torts, contracts, and property cases in the civil courts.<sup>89</sup> This analysis underlines that this may work in certain cases. In this conclusion, we wish to focus on two particular elements that distinguish between private and public law enforcement: the possibility of obtaining damages and the availability of investigative powers.

The risks and costs of engaging in a private lawsuit cause rational apathy to be more significant as the harm becomes smaller yet more widespread. Compensation as such is an important motivation for individuals to sue. No free riding is possible in relation to specific damage cases. Regarding injunctions, a free rider problem is more likely but may be mitigated by a low-cost procedure. Theoretically, there is a whole toolbox of funding possibilities, such as legal aid programmes, insurance, or a shifting of legal fees for the benefit of the plaintiff that could improve the individual's incentives within private law enforcement. In individual lawsuits, agency issues might be more moderate than in mass cases and judge impartiality prevails. Moreover, some procedures may not need to involve a lawyer. Importantly, certain civil lawsuits may not occur because necessary information (regarding evidence or the location of the wrongdoer) cannot be generated in a private law setting. Insolvency may be a problem because there is an emphasis on monetary sanctions. A major weakness seems to be that the information asymmetry regarding a wrongdoer's whereabouts has the potential to impede law enforcement in various ways and for which civil procedural law usually does not provide a solution. A civil judge is clearly limited when it comes to taking evidence compared to public law enforcement. Escaping wrongdoers are typically those that have the greatest incentive to generate substantial damage and thus the biggest losses for society.

In a certain sense, the state assumes many risks with administrative law enforcement. The free riding mentality and rational apathy can be remedied and, only if reporting is an issue, can they re-emerge to a certain extent. Thought must be given to ways of incentivizing people. Difficulties can arise where individuals are primarily seeking compensation that such an administrative agency cannot grant. In these situations, the individual might not be motivated to report; it

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left mainly as an underlying threat, according to I.A. OGUS, in: *New Perspectives*, concentrating on the relation between administrative law enforcement and criminal law enforcement.

89 See R.A. POSNER, *Economic Analysis of Law* (New York: Aspen Law & Business 2011), p 841. On tort, see W.M. LANDES & R.A. POSNER, *JLS* 1975, p 30.

Furthermore, the private and the social loss generally will be equal; for example, if a house burns down, there is a loss for society and also for the individual; see H.-B. SCHÄFER, *EJLE*, p 203 or VAN DEN BERGH, in: *Collective Enforcement of Consumer Law*, p 185.

depends on the amount of damage at stake for the individual. Public agencies, however, may have other means of obtaining information regarding legal violations (e.g., through their monitoring powers). This is where the most important complementarity with civil law enforcement emerges. This is where public enforcement can effectively enhance civil law enforcement. One question remains, that of how an entity selects the cases to pursue. Additionally, public agencies have alternative sanctions that will uphold the deterrent effect when probabilities of detection and/or conviction are low. The danger of capture is rather discussed regarding public officials than judges. Depending on the extent of officials' discretion, frivolous lawsuits could even be initiated on the agency's own motion or by individuals.<sup>90</sup> Error costs in general have a high likelihood of occurring, higher than in the criminal court and presumably higher than in the civil court. A court procedure is regarded as superior. Administrative costs very clearly depend on the amount of investigative and monitoring powers used; the desirability of investing these costs depends on the benefits that can thereby be achieved (in terms of deterrence).

Considerable costs and risks in a criminal procedure are allocated to the state. The allocation of risks is resolved smoothly, as the state is assumed to be the best risk bearer, providing the most pooling options. Victims can join in the procedure and there generally are provisions for suing for damages. Available investigative powers remedy many of the information asymmetry cases. Criminal law also remedies the judgment-proof problem through the availability of non-monetary sanctions.<sup>91</sup> Capture is unlikely with criminal judges and likewise the danger of frivolous lawsuits is low. Then again, the public prosecutor could be captured. However, initiating a procedure against an innocent person can inflict some damage. The danger of error costs is low, but if they occur, they may be serious because of the system's costly sanctions. Principal-agent issues occur between accused and lawyers and on the side of the victim as well if the victim joins the procedures. However, criminal law enforcement carries the highest administrative costs, and therefore, it is hardly feasible to advocate a general use of this branch of law. In terms of combining different mechanisms for the enforcement response, a cautious use of criminal law is warranted. Significantly, the reasons why criminal law enforcement is impossible (even though it seems to make up for all the weaknesses of the other mechanisms and is a mechanism that can provide for compensation payments and investigative powers) have to do with error costs, mistakes that always happen, certain people who will not respect the

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90 The idea that public officials would start frivolous lawsuits stands in contrast to the rule that they pursue their task in the public interest.

91 S. SHAVELL, *Colum. L. Rev.*

law, other individuals who cannot be deterred, and administrative costs.<sup>92</sup> If criminal law is supposed to be only a fallback option for the enforcement of European private law, then how can civil and administrative laws interact? As said, group litigation has not been considered within this setting; some effects would resemble those of public law enforcement.

How therefore can private and administrative law enforcement complement each other?

Focusing on two core criteria, incentives emanating from the prospect of compensation and investigative powers, the following can be said. For certain types of infringements, both may be necessary – compensation payments as a trigger and investigative powers.<sup>93</sup> As an example, one can refer to any rogue trader that causes substantial harm to consumers but asserts a considerable effort to remain undetected. Whereas the rational apathy problem is clearly interrelated with the question of which remedy can be obtained, for instance compensation, investigative powers impact the information asymmetry prevalent between the claimant and the defendant or the accused. Furthermore, how far free-riding behaviour may turn out to be a problem also depends on the remedy that can be sought. Private law enforcement can provide the one – compensation – and administrative law enforcement can provide the other – investigative powers. In terms of fine-tuning an enforcement response, there is a potential for administrative as well as criminal law to enhance private law enforcement. There are certain similarities in the weaknesses that both types of public law enforcement can cure. Therefore, it generally seems feasible to suggest using the lower-cost one, i.e., administrative law enforcement as long as the special powers vested in criminal law are not needed. Therefore, it is a fair question whether the current differentiation between administrative and private laws can still be fine-tuned. There are three options: The bodies could be more smoothly interrelated. This would mean that findings established in one could be used by the other (e.g., information generated by the authority used in the courts for actions such as follow-on damage claims); a civil judge's investigative powers could be increased or a public authority could add the power to grant compensation to its current set of powers. Such a restructuring may, however, have a number of effects. If, for example, procedures at a public authority started granting the remedy 'compensation', other aspects, such as the fees of the

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92 If an individual can be deterred by a system involving lower administrative costs, there is no need to revert to the criminal law. Administrative costs of criminal law make up a considerable share of overall societal costs.

93 F. WEBER, 'Assessing Existing Enforcement Mechanisms in Consumer Law - The Unavailability of an Allrounder', 3. *Swedish Journal of European Law (ERT, Europarättslig tidskrift)* 2011, pp 536-554.



procedure or the necessity to involve lawyers, may have to be changed likewise. Furthermore, administrative costs have to be kept within reasonable limits.

If any of such fine-tuning took place, criminal law should be reserved as a fallback option. It could be used for repeat offenders, cases of judgment-proof wrongdoers, and as a threat to civil servants if they do not comply with the requirements of their tasks. Criminal law, unlike administrative law, has the power to provide both: investigative powers and compensation. Therefore, one might argue that in countries where criminal cases regularly involve the assessment and granting of damage payments, an expansion of criminal law could be considered instead, as it involves fewer institutional changes for those particular countries.

## 5. An Application: The British Financial Sector

Financial services from the outset are an exemplary sector in which some non-benevolent traders act and cause harm to consumers. Therefore, an enforcement response in which not only compensation can be obtained but the relevant investigative powers are also available within the procedure would be crucial. The UK financial sector has recently undergone some regulatory changes and, in its current design, provides for some interesting avenues that allow a combination of both: compensation payments and investigative powers. While economic arguments clearly speak in favour of such a mechanism, few real-life examples exist. So, we shall present the key facts of this ‘jewel’ that we detected.

The key sectoral regulator in the banking sector is the Financial Conduct Authority (FCA), which is the successor to the Financial Standards Authority (FSA).<sup>94</sup> The FCA is concerned with rule-making, investigation, and enforcement. It challenges conduct infringing the financial regulations as set out in the Financial Services Act 2012. Its enforcement powers are wide and entail criminal ones (e.g., prosecutions) and civil and administrative ones (e.g., fines). The FCA carries out monitoring and investigations. It is risk-based and proportionate in its approach to supervision, engaging in proactive monitoring and event driven, reactive monitoring.<sup>95</sup> Overall, in 2013–2014, action was taken against 34 firms and 28 individuals (excluding threshold condition cases), 46 penalties were imposed totalling GBP 425 million, 124 final notices were issued, and four criminal convictions obtained.<sup>96</sup> The FCA has a number of investigative powers.

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94 We shall devote only minor attention to the other sectoral players: the Prudential Regulations Authority (PRA), the Financial Ombudsman Service (FOS), the Financial Services Compensation Scheme (FSCS), and the Money Advice Service.

95 *FCA Annual Report 2013/14*, p 16.

96 See for further details the annual report.

Among their channels to discover information are acquiring information from firms, as well as data analysis, whistleblowers, and consumer complaints.<sup>97</sup>

Importantly, there are two ways for individuals to obtain compensation within this administrative law structure.<sup>98</sup>

First, it is possible via restitution orders that need to go via the courts (s. 382-4 Financial Services and Markets Act 2000 (FSMA)). They are available in case of a violation that causes collective harm. Importantly, the investigative powers of the FCA can be made use of, e.g., access to documents, investigations regarding the amount of profits made, conduct, or questions of distribution of compensation.<sup>99</sup> Special investigators may be appointed according to sections 167 or 168 FSMA.

A second way to obtain compensation in the context of this public scheme is according to the Consumer Redress Scheme (s. 404(1) FSMA) that was introduced in 2010 under FSA.<sup>100</sup> A number of such schemes exist. Whereas the predecessor FSA had secured various of these schemes, in 2013 FCA used section 404 for the first time to impose a redress scheme following an industry-wide review into the sale of Arch Cru funds.<sup>101</sup> Such a scheme operates in cases of widespread or regular failures. Firms are then required to pay redress according to the criteria as set out by the FCA. Again, the investigative powers available to the FCA can be made use of in this process.

This short sketch shows that we see indeed a strong link between public and private law enforcement elements in the area of financial services in Britain, a model that law and economics theory would strongly support.

Attention should also be paid to the total administrative costs. It should be mentioned that there is an out-of-court dispute resolution system available in the financial sector that may absorb a large number of cases and deal with them in a low-cost way. The Financial Ombudsman Service (FOS) is set up under the provisions of Part XVI and Schedule 17 of the FSMA (as amended). Effectively a large number of complaints are handled via the scheme.<sup>102</sup> If a consumer was not satisfied with the FOS decision or opted for not making use of it, he could take the matter to the civil court, more specifically the county courts designed for dealing with small-scale cases.

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97 *FCA Annual Report 2013/14*, p 17.

98 See also C. HODGES, 'United Kingdom', in *Consumer ADR in Europe – Civil Justice Systems*, eds C. Hodges, I. Benöhr & N. Creutzfeldt-banda (Oxford and Portland, Oregon: Hart Publishing 2012), pp (253-338) 273.

99 See *The Enforcement Guide 01/04/2014*, s. 11.

100 See also the *FCA Handbook*.

101 <http://www.fca.org.uk/consumers/financial-services-products/investments/news-and-investigations/cf-arch-cru>.

102 See *Annual Report FSO*.

Subordinate to the sector regulators the Competition and Markets Authority (CMA)<sup>103</sup> and the local Trading Standards services may also play a role. They have a large number of enforcement powers, informal ones but also civil and criminal action can be taken. Additionally, in terms of criminal law enforcement with the Legal Aid, Sentencing and Punishment of Offenders Act (LASPO) 2012, the importance of compensation orders is increasing in the United Kingdom, making it a duty for courts to consider making a compensation order when victims have suffered a loss. Therefore, this option may also be gaining in importance, likewise facilitating compensation in the face of investigative powers.

In conclusion, there are a number of possibilities for combining compensation and investigative powers presented in this UK example. Claiming such interrelation is therefore not merely a theoretical possibility. The avenues that were shortly sketched allow for alleviating rational apathy and free-riding problems by ensuring both the availability of investigative powers and the possibility of compensation being awarded.

## 6. Conclusion

This article deals with the comparative advantages of public and private law enforcement from a law and economics perspective. The analysis sets out their respective strengths and weaknesses. By focusing on the rational apathy and free riding problems and linking those to the prospect of compensation and the availability of investigative powers that can reduce information asymmetries, it is shown how a fine-tuning between both instruments can generate positive enforcement results. Of course, the picture provided in this article is not the entire story. The goal of this article was to provide criteria in order to assess various enforcement mechanisms, particularly in the light of the interdependencies between public and private enforcement. Hence, this approach could also be applied to yet other enforcement mechanisms that remain untouched in this article, such as collective enforcement mechanisms.

Which (combination of) enforcement mechanisms is optimal in European private law will to a large extent also depend on the specific case, sector, or scenarios addressed. Moreover, in addition to examining how current enforcement mechanisms could be optimally combined, another (undoubtedly interesting) approach would be to examine whether particular enforcement mechanisms separately could also be restructured and strengthened. Such an exercise could again take into account the potential of combinations with other mechanisms.

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103 See CMA, *Consumer Protection: Guidance on the CMA's Approach to Use of Its Consumer Powers* (2014).

The advantage of this theoretical approach is that it becomes equally possible to address new combinations, such as using investigative powers of the public enforcement in combination with compensation (which was traditionally not possible). The British case study concerning the financial sector shows that such a combination is indeed available.

Finally, we should stress that this analysis largely remained within the traditional rational choice paradigm and assumed that most actors (at least public enforcement bodies) were acting in the public interest. By touching upon capture problems, we have already incorporated the public choice approach to enforcement. Yet another relevant question would be how behavioural biases could equally affect the behaviour of the various actors involved and thus the smart mix between different enforcement mechanisms. This is undoubtedly an interesting issue for further research.