Dispersed losses in tort law. An economic analysis

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Articles

Michael Faure and Franziska Weber

Dispersed Losses in Tort Law – An Economic Analysis

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Abstract: From a law and economics perspective tort law is to serve two important functions: deterrence of wrongdoers and victim compensation. We can easily construct examples of torts leading to small and widespread harm for which it is questionable whether a rational victim will initiate an individual lawsuit. This is mainly true because of rational apathy, free-riding problems and information asymmetries. In this paper we assess various funding and insurance options that are available with a view to improving the individual's risk ratio and the potential of out-of-court dispute resolution mechanisms to capture small claims. Next, we consider the attribute 'widespread' and, therefore, look at any solution that would involve grouping claims, thereby leading to cost-reductions for the individual. Public law enforcement functions in a way similar to grouping claims because a collective matter is dealt with in one proceeding and individuals are relieved of (most of) the litigation costs. Combinations of public and private means are likewise possible. Throughout the analysis we will differentiate cases of small and widespread and very small and widespread harm. For the latter the threat of collective compensation claims is neither credible nor economically feasible. This calls for an investigation of alternative remedies to compensation, such as skimming off procedures, fines or punitive damages that uphold the deterrent effect. In addition to the theoretical analysis, we will refer to current EU policy where applicable.

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*Corresponding author: Michael Faure, Professor of Comparative and International Environmental Law, Maastricht University; Professor of Comparative Private Law and Economics, Erasmus University Rotterdam, the Netherlands. At the time of writing, haiwaimingshi (distinguished foreign professor) at the Research Centre for Law and Economics of the China University of Political Science and Law (CUPL), E-Mail: faure@law.eur.nl

Franziska Weber: Junior Professor, Institute of Law and Economics of the University of Hamburg, Germany, E-Mail: franziska.weber@uni-hamburg.de

I Introduction

The starting point for a regulatory intervention seen from within ‘law and economics’ is a market failure. The primary market failure experienced in tort law consists of a negative externality. Such an externality exists whenever one individual is adversely affected by another individual’s – the tortfeasor’s – activities. ‘Adversely affected’ in this context means that the other individual’s well-being is reduced and the individual is not compensated for it. In the economic analysis of law, accident law in general, and liability rules in particular, are considered as important tools to remedy market failures caused by negative externalities. In order to internalise those externalities, the economic approach to accidents has pointed to the importance of exposing tortfeasors to the harm they cause by making them liable for it.¹ The basic idea is that by exposing tortfeasors to the social costs of their activity, they will have *ex ante* incentives to take optimal preventive measures. This perspective reasons from the angle of the deterrence function of tort law that induces compliant behaviour by potential wrongdoers in the sense that they take optimal care. This is the primary function for an economic analysis.² The second crucial function of tort law is that of victim compensation.³

These are the foundations of tort law from an economic point of view. While the deterrence approach is said to work for a variety of torts, for instance within accident law or medical malpractice, for a number of reasons, this ideal model concerning the preventive effect of tort law is challenged in the case of large and widespread harm. The core reason is a potential enforcement failure. When harm is spread over a large number of individuals, the harm suffered by each individual separately may be relatively small, although the total harm could, from a societal perspective, be substantial. However, precisely because the harm suffered by the individual may be relatively small, that individual may not be willing to take action against the tortfeasor. The simple reason is that the individual victim would have to invest substantial amounts of time and money in carrying out a lawsuit against the tortfeasor, whereas his individual loss may be relatively limited. Moreover, the problem may be that if he were to bring such a lawsuit aiming, for instance, at preventing further harm being caused by the tortfeasor, the benefits could be for all persons who were affected by the wrong, whereas only the one bringing the lawsuit would bear the costs. The other victims (who

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¹ See in this respect the seminal book by *G Calabresi*, *The Costs of Accidents* (1970).

² The sanction is determined by the probability of being detected and convicted; see *GS Becker*, *Crime and Punishment* (1968) 76 *Journal of Political Economy* (*J Pol Econ*) 169.

³ For the goals of tort law, for instance, see *D Rosenberg*, *Decoupling Deterrence and Compensation Functions in Mass Tort Class Actions for Future Loss* (2002) 88 *Virginia Law Review* 1871.

were not engaged in the lawsuit) could under certain conditions take a free-ride with the individual who brings the suit. It is precisely this danger (and at the same time the possibility) of free-riding that will prevent the individual from investing substantial amounts in a lawsuit that could only bring small benefits to him but large benefits to society, that is, others. Therefore, even though the total social harm in case of dispersed losses may be large, a lawsuit will probably never be brought precisely as a result of rational apathy⁴ and the free-riding problem. Therefore, in the case of dispersed losses, the deterrence goal of tort law cannot be achieved. This would consequently result in the continuation of the market failure related to the negative externality resulting from a tort. Dispersed losses, therefore, cause social costs. From an economic perspective one can justify the discussion of solutions, as a result of which dispersed losses can be internalised – as induced by the law enforcement process. Note that in addition to the under-deterrence, at the same time the second goal, that of victim compensation, cannot be reached as the enforcement response will be lacking.

This contribution will examine the theoretical possibilities, that is, the legal instruments that could be used to force a tortfeasor to internalise dispersed losses also. We will do so by using the economic approach to law. By looking at individuals' incentives we can assess if changes in law enforcement will increase or decrease the likelihood that a successful lawsuit be brought. This allows addressing the costs and benefits of a variety of different possible solutions. Cost-benefit analysis tells us whether there can be an overall increase in welfare with certain legal reforms or innovations. To facilitate the illustration of the different solutions, throughout the analysis we will differentiate between cases of small and widespread harm and cases of very small and widespread harm. Moreover, we will equally address the extent to which the various options that would theoretically be possible can also be found in practice, more particularly in current EU policy.

In order to illustrate the problem of dispersed losses, we will start this contribution with two examples (II) and then discuss a variety of options which could be used as a response to cases of small and dispersed damage (III). Section III will review five different potential reactions to enforcement shortcomings, each time presenting the economic arguments in favour of, and against, a

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⁴ See *RJ Van den Bergh*, Should Consumer Protection Law be Publically Enforced? An Economic Perspective on EC Regulation 2006/2004 and its Implementation in the Consumer Protection Laws of the Member States, in: *W van Boom/MB Loos* (eds), *Collective Enforcement of Consumer Law. Securing Compliance in Europe through Private Group Action and Public Authority Intervention* (2007) 184; see *WM Landes/RA Posner*, The Private Enforcement of Law (1975) *Journal of Legal Studies* (JLS) 1, 29, 33.

particular solution and equally presenting the current EU policy with respect to the particular option. Section IV concludes.

II Examples

A few examples can illustrate the problems we have sketched in the introduction. In both cases, a market failure will emerge and continue for similar reasons, in essence because there is no plaintiff who will bring a lawsuit.

A Acid rain case

Suppose that country A is emitting substances that are carried by the wind and cause substantial damage to the forests in countries B and C. Forests partially die, largely reducing the touristic attractiveness of particular areas. This can lead to various types of losses. Individuals could suffer discomfort from the reduced beauty of the forests. Many businesses in the tourist sector could also incur damage to different degrees (substantial, small and very small damage).

B Mobile phone overcharging

Suppose that various mobile phone providers in country D fix prices, in violation of competition law as a result of which consumers in country D pay too high a price for their use of the mobile phone. The average loss per consumer is approximately € 15 per month (= very small damage); the average income in country D is € 1,200.

To start with take the example of a world, in which tort victims can bring individual lawsuits in the civil court.⁵ In both cases, it is doubtful if a legal action will be brought against the tortfeasors who (supposedly) acted wrongfully. From an economic perspective, not bringing a lawsuit is straightforward: enforcing one's rights means that litigation fees and legal expenses have to be borne; the tort victim has to invest money and time. The individual costs of a trial (and more

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⁵ It should be mentioned that small and widespread losses not only occur as a result of torts, but can equally happen within contract law. The challenges and solutions proposed from an economic point of view are to a large extent also valid in the context of law enforcement due to a contractual breach. Our case A may be a tort case, whereas case B would in many legal systems probably be treated as a contract case.

particularly the lawyers' fees) will be too high, compared to the potential benefit.⁶ Not suing is, therefore, rational. This scenario has been described in the introduction. The free-rider mentality is remedy-dependent and may increase this pre-existing rational hesitancy to bring a case. If the forests recovered because the emissions were interrupted, everyone would, for instance, profit from one individual who obtained an injunction against the factory.

An aggravating factor concerns the issue that, even if the individual were willing to pay the court and lawyers' fees and were willing to invest time to initiate a lawsuit, there may be an important problem of lacking information on the side of the victim.⁷ In both the examples we gave, the problem may arise that the victim may, for instance, not be aware at all that the event that caused damage to them was actually wrongful. Lacking information may thus also restrict the possibilities of a lawsuit.⁸ The investigative powers, of for instance the judge, available within the context of a private individual lawsuit are limited. Within other enforcement systems, such as involving public authorities, this may be different. This information asymmetry, consequently, is a third important factor at play when it comes to obstacles to law enforcement which would be desirable from a societal point of view.

When taking individual civil litigation as the point of departure, the market failure of harm not being internalised by tortfeasors persists with regard to small and widespread damage. Various refinements and enhancements of civil litigation exist in practice and theory to cure the failure of socially desirable (meritorious) lawsuits being brought.

III Improving the legal response for cases of small and dispersed damage

To remedy the market failure that we have established in the previous section by enabling an adequate law enforcement response, a variety of solutions can be imagined. Within a first set of solutions we discuss procedural avenues from

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⁶ See *H-B Schäfer*, The Bundling of Similar Interests in Litigation. The Incentives for Class Actions and Legal Actions taken by Associations (2000) 9 European Journal of Law and Economics (EJLE) 183.

⁷ See generally *S Shavell*, Liability for Harm versus Regulation of Safety (1984) JLS 357.

⁸ See *R Van den Bergh*, Private Enforcement of European Competition Law and the Persisting Collective Action Problem (2013) 1 Maastricht Journal 12, 17 regarding competition cases and information asymmetries.

within private law (aiming at the improvement or enhancement of the functioning of private law)⁹ and, then, enforcement responses from public law – this can mean administrative or criminal law. To some extent, it may equally be possible to imagine a hybrid solution whereby private and public enforcement are combined.

All of those solutions, which will be sketched and reviewed in this section, have advantages and disadvantages. They work under different sets of conditions and may consequently be more or less suited for specific cases or contingencies. We address those different legal instruments by using the economic method of cost-benefit analysis. A legal solution will be endorsed if the additional benefits which it generates outweigh the costs. Benefits can be measured as the ability to overcome the stated problems, which enables a law enforcement response, thereby ensuring that the deterrence and compensation goals of tort law can be achieved. Costs emerge in terms of the administrative costs of implementing the add-ons and new behavioral challenges they may entail. This allows us to provide some indications on the type of legal instrument that may, under particular circumstances, be the appropriate solution for the market failure in a specific case.

A Procedural private law solutions for individual lawsuits

We can envisage a variety of solutions to remedy the (rational) cost aversion of the individual, which could thereby potentially increase access to justice and cure the market failure. Partly these can be found directly within the procedural laws. The extent to which an individual has to pay for litigation fees, will have an impact upon his assessment of the risks.¹⁰ In this sense fee shifting rules are crucial. The prevailing system in Europe is the loser-pays rule.¹¹ Likewise, procedural rules on the burden of proof impact the calculation. In this section we will focus on some solutions that can actually relieve the individual of a financial burden.

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⁹ For our definition of private law enforcement, we would go as far as including means of alternative dispute resolution.

¹⁰ See *AJ Duggan*, Consumer Access to Justice in Common Law Countries: A Survey of the Issues from a Law and Economics Perspective, in: CEF Rickett/TGW Telfer, *International Perspectives on Consumers' Access to Justice* (2003) 66.

¹¹ *C Hodges/S Vogenauer/M Tulibacka*, The Costs and Funding of Civil Litigation – A Comparative Perspective (2010) 28: In almost all jurisdictions the general position is that the loser pays the costs of the court, evidence and lawyer (in civil litigation). Some exceptions are possible.

1 Legal expenses insurance

To use insurance techniques is, in principle, relatively simple: the insurer takes over the risk of having to pay legal expenses from the risk-averse plaintiff, thereby increasing the chances that meritorious claims will be brought. The classic legal expenses insurance is a before-the-event insurance (also abbreviated as BTE) whereby a risk-averse individual seeks coverage *ex ante*.¹² In the basic model the procedural risk (and hence the expenses) are shifted to the insurance company. The insurer will function as a gate keeper and screen the cases on their merits. As a result in principle only meritorious claims will be brought.¹³

Another possibility is to buy insurance after the event on an *ex-post* basis, referred to as after-the-event insurance (ATE). It can be questioned whether ATE insurance still qualifies as an insurance contract since the premium in fact amounts to a contingency (a proportion of the proceeds) that the winning insured would have to receive from his injurer once the case is won after the event.¹⁴

Insurance solutions have many obvious advantages. Insurance transforms risks into certainties as preferred by risk-averse individuals. A surprising empirical fact is, however, that notwithstanding the theoretical advantages of legal aid insurance very few individuals in fact seem to buy those insurance policies. Even in legal systems where the insurability of legal expenses would be large (*inter alia* given fixed fee systems like in Germany) the coverage is on average not very high.¹⁵ The only European systems with high coverage for legal expenses insurance is a country like Sweden where legal expenses insurance is mandatorily added on to health care insurance.¹⁶

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¹² For details see *WH van Boom*, Financing Civil Litigation by the European Insurance Industry, in: *M Tuil/L Visscher* (eds), *New Trends in Financing Civil Litigation in Europe – A Legal, Empirical and Economic Analysis* (2010) 92.

¹³ See *M Tuil/L Visscher*, *New Trends in Financing Civil Litigation in Europe: Lessons to be Learned* 175 and *L Visscher/T Schepens*, *A Law and Economics Approach to Cost Shifting, Fee Arrangements and Legal Expense Insurance* 7, both in: *M Tuil/L Visscher* (eds), *New Trends in Financing Civil Litigation in Europe – A Legal, Empirical and Economic Analysis* (2010).

¹⁴ See *van Boom* (fn 12).

¹⁵ For an overview see *M Kilian*, *Alternatives to Public Provision: The Role of Legal Expenses Insurance in Broadening Access to Justice: The German Experience* (2003) 30 *Journal of Law and Society* 36; *F Regan*, *Whatever Happened to Legal Expenses Insurance?* (2001) 26 *Alternative Law Journal* 293 and see also *M Kilian/F Regan*, *Legal Expenses Insurance and Legal Aid – Two Sides of the Same Coin? The Experience from Germany and Sweden* (2004) 11 *International Journal of the Legal Profession* 238.

¹⁶ See on the Swedish model *F Regan*, *The Swedish Legal Services Policy Remix: The Shift from Public Legal Aid to Private Legal Expenses Insurance* (2003) 30 *Journal of Law and Society* 49.

It is not exactly clear why, notwithstanding the economic benefits, there is such a low demand for legal expenses insurance.¹⁷ In sum, insurance solutions may theoretically be available in many legal systems, but many individuals simply do not purchase them. A reason may be that they assess the probability of being involved in a lawsuit as low. In the absence of a mandatory system, insurance may therefore not help the consumer.

2 Any funding of litigation costs

The individual's litigation costs can be reduced by various funding options, which would consequently lead to meritorious or socially desirable cases involving small and widespread harm ending up in court.

a Legal aid (for a selected group of individuals)

Traditionally, legal systems always had financing systems to allow access to justice, also for those in financial need. However, with reduced public budgets, in many countries the financing of legal aid has been substantially reduced.¹⁸ Whereas legal aid is capable of improving the risk ratio, its design may be problematic. One issue is that an ex ante monitoring of the meritorious character of a lawsuit is important in order to determine whether the suit really merits legal aid. That can create administrative costs (in a similar way as these emerge for insurers). Second, a mechanism needs to be designed to structure the financing of the lawyer, working on a legal aid basis, in such a way that optimal incentives for good performance are provided. The problem is that since the client does not directly finance the lawyer, he may lack (financial) incentives to monitor the quality of the work exercised by the lawyer. An agency financing the legal aid will hence have to control the financing which again creates additional costs. Moreover, to the extent that legal aid provides a lower remuneration than what lawyers could otherwise earn, a negative selection could take place whereby only the young and inexperienced lawyers (who do not yet have a large well-paying

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¹⁷ For an overview of the possible explanation see *MG Faure/J De Mot*, Comparing Third-Party Financing of Litigation and Legal Expenses Insurance (2012) 8 *Journal of Law, Economics and Policy* 743.

¹⁸ For example in the UK: *C Hodges*, Global Class Actions Project, Country Report: England and Wales (2008) 26; see also *R Moorhead*, Cost Wars in England and Wales: The Insurers Strike Back, in: M Reimann (ed), *Cost and Fee Allocation in Civil Procedure* (2012).

clientele) would be interested in taking legal aid cases.¹⁹ This could in turn jeopardise the quality of the work done and hence the likelihood that meritorious suits are successfully brought.

b Transfer of claim

Another funding alternative is to transfer a claim to a third party. A transfer supposes that the victim sells the claim to a third party who purchases the claim and, of course, pays a lower price than the total value of the claim.²⁰ The advantage of such a transfer for the victim is obvious: he may have a possibility to receive compensation quickly of a certain amount without costs and risks. Of course, the victim will not receive full compensation since the buyer will reduce the value of the claim with a risk premium given the uncertainty of recovery.²¹

It seems like an interesting and attractive model, but is not used that often in practice. First of all many legal systems do not allow such a transfer of a (liability) claim.²² Another problem is that, even in legal systems that do allow a transfer of claim, coordination and information difficulties may arise during litigation;²³ the purchaser of the claim may still depend on the seller for example to obtain information to make his claim successful. The incentives of the victim, who sold the claim and hence has already cashed in, to actually cooperate during litigation may be limited, and this could jeopardise the attractiveness of the system altogether.

c Third party funding

A model which looks like a transfer of a claim, but still is different, is a system whereby a third party finances litigation (third party funding or abbreviated TPF) against a payment which can consist in part of the proceeds in the event of

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19 Whether legal aid necessarily implies a lower quality of legal services depends strongly upon the legal system. In some legal systems it is indeed only the younger lawyers who take legal aid cases; in other countries also large specialised law firms still do a substantial amount of so-called ‘pro bono’ work.

20 For the mechanics of this see *A Pinna*, Financing Civil Litigation: The Case for the Assignment and Securitization of Liability Claims, in: M Tuil/L Visscher (eds), *New Trends in Financing Civil Litigation in Europe – A Legal, Empirical and Economic Analysis* (2010).

21 See *Tuil/Visscher* (fn 13) 187 f.

22 For details on the attitudes of the legal system, see *Pinna* (fn 20).

23 See also *Tuil/Visscher* (fn 13) 188.

success.²⁴ The way it usually works is that a private company offers the plaintiff cash in exchange for a property interest in an unresolved lawsuit. The enterprise will usually offer cash in the form of an advance on the settlement amount. Third party funding has become very popular in the US,²⁵ but so far has not been very popular in Europe.²⁶ A few examples exist, however. For example the Ombudsman in Sweden will fund claims for a small number of selected cases.²⁷

d Conditional fee agreement

With a conditional fee agreement (CFA) in this particular case we simply refer to a method of paying the lawyer on the basis of the result obtained by the lawyer.²⁸ A CFA contains two elements, a ‘no-win-no-fee’ provision and a fee increase if the case is dealt with successfully. Therefore, a successful lawyer will obtain the ‘normal’ basic fee, calculated on an hourly rate, and additionally the success fee (a proportion of the basic fee). In fact such CFAs are similar to contingency fees, the resistance towards which is strong throughout Europe.²⁹ Research has indi-

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24 See on the economics of third party funding *KN Hylton*, The Economics of Third-Party Finance Litigation, Boston University School of Law Working Paper, number 11–57 (2011), <<http://www.bu.edu/law/faculty/scholarship/workingpaper/2011.html>> or at <<http://ssrn.com/abstract=1971229>>.

25 For details see *D Hensler*, Financing Civil Litigation: The US Perspective, in: M Tuil/L Visscher (eds), *New Trends in Financing Civil Litigation in Europe – A Legal, Empirical and Economic Analysis* (2010) 153. She refers ‘for example’ to websites like <www.fundmysuit.com> where enterprises offer funding for litigation.

26 For experiences with third party funding in Europe see *M Steinitz*, Whose Claim is it anyway? Third Party Litigation Funding (2011) 95 *Minnesota Law Review* 1268.

27 See § 2 of *Svensk Författningssamling* (Swedish Statute Book, SFS) 2011:1211. The preconditions for an intervention are that ‘the dispute shall either be significant for the application of the law, i.e. to clarify the legal situation within a certain area, or the dispute shall be of common consumer interest, i.e. concern a great number of consumers’, translation provided on <<http://www.konsumentverket.se/otherlanguages/English/This-is-how-you-apply-for-KO-support/>>.

28 For a more nuanced approach to the different categories of result based remuneration of lawyers see *MG Faure/FJ Fernhout/NJ Philipsen*, No Cure, no Pay and Contingency Fees, in: M Tuil/L Visscher (eds), *New Trends in Financing Civil Litigation in Europe – A Legal, Empirical and Economic Analysis* (2010) 33.

29 Under contingent fees the attorney gets a share of the award. With a CFA on the other hand, the attorney gets a reward not related to the adjudicated amount. For an overview of rules in various countries, see *MG Faure/FJ Fernhout/NJ Philipsen*, *Resultaatgerelateerde Beloningssystemen voor Advocaten – Een Vergelijkende Beschrijving van Beloningssystemen voor Advocaten in een Aantal Landen Van de Europese Unie en Hong Kong* (2009). Some countries are experimenting with different shapes of such remuneration schemes.

cated that some form of result-based remuneration exists in many legal systems, although the precise shape may differ.³⁰

Conditional fees have a strong economic appeal for the simple reason that they align the incentives of the clients and the lawyer.³¹ From the perspective of the victim the main advantage is the risk reduction. An advantage of a result-based remuneration system is, moreover, that it provides strong incentives for lawyers to monitor the quality of cases *ex ante* and thus that excessive or frivolous litigation would be avoided, since lawyers would only have an incentive to accept meritorious cases. This seems to be confirmed in empirical research by Helland and Tabarrok, indicating that contingency fees, of a similar nature to CFA, discourage the filing of low quality suits and hence increase the legal quality of cases.³²

Overall, notwithstanding the potential advantages of each of those solutions, they do not always exist on a large scale in practice. In some cases, they are underused (legal expenses insurance) or used only to a limited extent (third party funding) or even prohibited by law (transfer of claim or conditional fee agreement in some legal systems, and clearly contingency fee agreement). Arguably in this section we have not simply dealt with how individual claims can be induced but, to some extent, we have already discussed systems that require that a whole group of individuals is affected.

3 Alternative Dispute Resolution (ADR)

The question arises if alternatives to civil litigation, such as ADR or mediation, have the potential to overcome some of the problems we have discussed so far.³³ The economic perspective concerning ADR is relatively simple: if ADR is able to reach speedy decisions at low costs and of high quality it should, of course, be welcomed especially if it could be held that the total cost of an ADR procedure would be lower than the costs of handling a similar claim through the court system.³⁴ Generally the costs of solving cases via an ADR system are, because of

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³⁰ See *Faure/Fernhout/Philipsen* (fn 28).

³¹ Which in some legal literature is precisely considered as problematic since lawyers are not supposed to have a stake in the outcome of the case.

³² See *E Helland/A Tabarrok*, Contingencies Fees, Settlement Delay and Low-Quality Litigation: Empirical Evidence from Two Data Sets (2003) 19 *The Journal of Law, Economics and Organization* 517.

³³ We will focus on ADR solutions in the following.

³⁴ It is held in the literature that self-regulatory mechanisms like ADR may be able to achieve compliance at significantly lower administrative costs than through public enforcement processes. Moreover, it is equally held that consumers and consumer associations may be motivated

flexible and simple rules of evidence and procedure, presumed to be substantially lower than the cost of the civil court system.³⁵ Given the lower evidentiary threshold and easier procedure (without the involvement of lawyers) one can also expect the ADR system to reach speedier decisions.³⁶ ADR systems aim to provide low-cost solutions to plaintiffs. Typically no fees or only a nominal fee has to be paid by the users. Therefore, such solutions have a potential to capture cases of low value for which rational apathy would play within civil litigation. Free-riding may also be less of an issue if the individual's costs involved are low. ADR systems are typically part of consumer dispute resolution and border-lining self-regulatory schemes involving industry members. The presumed advantages of self-regulation are that it generates better information (since traders – experts – and consumers would be better informed than bureaucrats). Thus such a system would, given the information advantage, be able to solve cases at lower costs than a court system that falls short on an informational advantage that only experts can solve.³⁷ Moreover, given the self-regulatory nature of ADR the system is often privately financed (by industry),³⁸ which may have substantial advantages in providing incentives for cost reduction.³⁹

From society's perspective, there are a few potential downsides. A first point is that it has to be remembered that the involvement of lawyers and the evidentiary and procedural rules in the civil court system are, of course, not pointless. They are meant to contribute to better fact-finding and a correct application of legal rules and hence to increase the quality of the decisions. Hence the speedier lower cost decisions without involvement of professional lawyers in the ADR could potentially lead to more erroneous decisions or, in economic terms, increase error costs. A factor that may add to this is the varying, and not necessarily balanced, composition of such ADR boards and committees. Economists would generally hold that there is a trade-off in the sense that the core advantages of ADR (in terms of lower administrative costs) would have to be compared to the

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to pursue the case in an efficient way, whereas public enforcement agencies may lack the same motivation. See *MG Faure/A Ogas/N Philipsen*, *Curbing Consumer Financial Losses: The Economics of Regulatory Enforcement* (2009) 31 *Law and Policy* 161.

35 See *Faure/Fernhout/Philipsen* (fn 28); *G Wagner*, *Private Law Enforcement Through ADR: Wonder Drug or Snake Oil* (2014) 51 *Common Market Law Review* (CMLR) 165, 183.

36 This is, for instance, true in the context of consumer ADR.

37 See on the advantages of self-regulation inter alia *A Ogas*, *Rethinking Self-Regulation* (1995) 15 *Oxford Journal of Legal Studies* (OJLS) 97.

38 This is not always the case. The Swedish consumer ADR system is, for instance, government-financed.

39 On the other hand, the payment structure can make a case for introducing regulation against biased decision-making.

potential dangers (in terms of increased error costs).⁴⁰ In cases where these advantages outweigh the costs, using ADR is in society's interest. This can obviously be the case when the issues at stake concern, for example, only a material loss (and not, for example, personal injury), when the amounts are relatively limited and where the facts of the case are relatively simple as a result of which also the ADR board can be assumed to reach correct decisions not resurting in error costs.

A second danger with any system involving low costs and low thresholds is that it could attract frivolous suits due to its reduced procedural accuracy.⁴¹ This can potentially be a danger, but ADR systems can also build in controls in the admission stage to avoid wasting time on frivolous suits. A third potential problem, already briefly referred to, is related to the danger of capture.⁴² An ADR body instituted by industry could constitute a monopoly and not be sufficiently independent. Especially if the system is also financed by traders the simple question can be asked: can you trust ADR bodies?⁴³ Again, this is a point that merits attention. Guarantees could be built into the system, for example, involving traders as well as consumers or independent experts to guarantee an objective decision-making of high quality.

A final point is that ADR systems are usually concluded on a voluntary basis or only bind traders that are member of a particular trade organisation. This always raises the question what to do with the so called 'rogue' traders that do not wish to be a member of the trade association and do not wish to join the ADR. On the one hand one could expect a kind of branding advantage of joining the ADR: it could lead to a reputational reward for the trader if he would join the ADR. However, there is always a danger that consumers do not recognise the branding or are not aware whether a particular trader joined the voluntary system or not. In that case rogue traders could effectively free ride on the collective efforts of the sector without having to pay for it. Involving the rogue traders or clearly signaling

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⁴⁰ To some extent this may be mitigated by the involvement of experts.

⁴¹ A point that is also stressed by *F Weber*, *The Law and Economics of Enforcing European Consumer Law – A Comparative Analysis of Package Travel and Misleading Advertising* (2014).

⁴² *TO Main*, *ADR: The New Equity* (2005) 74 *University of Cincinnati Law Review* (U Cin L Rev) 329, 330; *D Hodges/I Benöhr/N Creutzfeldt-Banda*, *Findings and Conclusions*, in: *D Hodges/I Benöhr/N Creutzfeldt-Banda* (eds), *Consumer ADR in Europe – Civil Justice Systems* (2012) 444: 'a certain vulnerability to capture by special interests, some consumer ADR schemes are currently not satisfactory concerning independence.'

⁴³ For an overview of empirical studies on this point, see *R Drahozal/S Zyontz*, *Empirical Study of AAA Consumer Arbitrations* Samantha (2010) 25 *Ohio State Journal on Dispute Resolution* 843–930.

to consumers which traders joined the ADR system and which not hence remains an important point of attention.

Low cost out-of-court solutions as exemplified by consumer ADR reduce costs for litigants, whereby ADR solutions amount to a funding device similar to the previously mentioned options. Out-of-court solutions could likewise take the form of mediation or Ombudsman schemes. Manifold variations exist. Also, within court procedures, special procedures for so-called small claims exist. The special procedural rules may not require a lawyer to be involved for certain low-value claims and reduced court fees. Such routes are to some extent fulfilling similar functions, enhancing each other or competing with one another. We choose to exemplify our point with a view to ADR as the more pronounced of the solutions in Europe.

With all potential solutions to reduce the litigants' costs (putting them in a viable relation to the benefits that can be obtained) there will be a lower limit as to when individual cases of low damage will not be brought either way. Whereas such solutions can capture a variety of low claims, there is a limit for very small, trifling harm.⁴⁴ For such cases more use may have to be made of the fact that the harm is also widespread and ways need to be found for a joint financing of such claims. This will be dealt with in the next section after a short word on current EU policy with a view to funding individual civil litigation.

4 Current EU policy

The European legislator has recently adopted a new Directive on Alternative Dispute Resolution (ADR) in the field of consumer law.⁴⁵ Importantly, unlike the current situation in the EU, it imposes the availability of ADR bodies for every commercial sector⁴⁶ which Member States will have to implement by July 2015. All ADR entities will have to meet quality criteria in line with the requirements set out

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⁴⁴ In practice there are minimum thresholds for ADR procedures, legal aid or other funding devices.

⁴⁵ See Directive 2013/11/EU of the European Parliament and of the Council of 21 May 2013 on alternative dispute resolution for consumer disputes and amending Regulation (EC) No 2006/2004 and Directive 2009/22/EC (Directive on Consumer ADR), Official Journal (OJ) L 165, 18.6.2013, 63–79. It was adopted together with a regulation on Online Dispute Resolution (Regulation (EU) No 524/2013 of the European Parliament and of the Council of 21 May 2013 on online dispute resolution for consumer disputes (Regulation on Consumer ODR), OJ L 165, 18.6.2013, 1–12). The latter sets up an online platform for dispute resolution as a single point of entry for the out-of-court resolution of online disputes.

⁴⁶ With the exception of health, education and non-economic services of general interest.

in the Directive. This goes for domestic as well as cross-border disputes. The Directive aims at minimum harmonisation. It leaves some discretion on the specific form of ADR to be implemented in the Member State. They may, of course, also have such bodies for fields other than consumer law. This legislative action is the result of an existing European interest in such measures.

Before the adoption of Directive 2013/11, a small claims procedure for cross-border violations was enacted in 2009.⁴⁷ It is valid for a claims level of up to 2000 Euros. The small claims procedure is currently being revised by raising the threshold. These two initiatives may enhance each other. The success of each route will depend, not least, on the Member State where it will be implemented.

The recent Commission Recommendation⁴⁸ regarding collective redress sets out a number of common European principles that will be referred to in the following section. Let us already mention that this document confirms the position that Europe is against any introducing contingency fees on a large scale: The respective recommendation reads as follows:

Legal representation and lawyers' fees

29. The Member States should ensure that the lawyers' remuneration and the method by which it is calculated do not create any incentive to litigation that is unnecessary from the point of view of the interest of any of the parties.

30. The Member States should not permit contingency fees which risk creating such an incentive. The Member States that exceptionally allow for contingency fees should provide for appropriate national regulation of those fees in collective redress cases, taking into account in particular the right to full compensation of the members of the claimant party.

The other funding solutions have not been harmonised at European level but are for each Member State to determine individually.

B Procedural solutions expanding individual to group litigation

So far, we have shown that there are a lot of different legal instruments that can, at least theoretically, be used to deal with the problem we identified as a cause of the market failure, being the aversion of the potential plaintiff against the risk of

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⁴⁷ Regulation (EC) No 861/2007 of the European Parliament and of the Council of 11 July 2007 establishing a European small claims procedure, OJ L 199, 31.7.2007, 1–22.

⁴⁸ Commission Recommendation of 11 June 2013 on common principles for collective redress mechanisms in the Member States for injunctions against and claims on damages caused by violations of EU rights, COM(2013).

high litigation costs. Moreover, we equally examined to what extent ADR could be an alternative to the civil litigation system. Expanding our view from improving individual litigation, it can be stated that the crucial feature of dispersed losses, as presented in the examples above, is that the one potential plaintiff is not alone, but that many others may be in a similar situation. The fact that losses are scattered over a large number of victims may, as mentioned, lead to a relatively small loss for each of them, or at least to an individual loss which is too low to stimulate a claim. The aggregate loss of all victims will, however, generally be substantial and bringing the lawsuit would often be socially beneficial.⁴⁹ This merits the question whether bringing a group action (rather than individual litigation) would not be one possibility to remedy the rational apathy problem. In addition, bringing individual claims together into group litigation may equally be justified from the perspective of economies of scale and procedural efficiency. We will briefly review on the one hand the so-called class action, also referred to as collective action or group litigation (usually applied in the American context) and on the other hand the representative actions (which are more common to Europe). Regarding the remedy we focus on proceedings for mass compensation.

Class and representative actions share some common aspects: the starting point is that granting the right to a group to act on behalf of all individuals that suffered a loss may reduce the rational apathy⁵⁰ because costs can now be shared collectively and hence spread to all individuals. Bundling of the claims allows a lower cost per individual. This, so the theory predicts, will lead to more claims being filed and hence to increased deterrence.⁵¹ There is also empirical evidence supporting that claim: Eisenberg and Miller found that the costs of individual litigation and legal counseling decreased with the increasing number of participants in a class action.⁵² One can also think of designs that reduce the free-riding mentality, if strictly only those who contribute to the proceedings are allowed to profit from them.⁵³ Whereas these aspects are the potential advantages, there are also additional cost factors. We will discuss various designs in the following part.

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⁴⁹ Another question would also be if large but widespread losses should be bundled. This may be at play in scenarios like our first case example (A).

⁵⁰ See *S Keske/A Renda/RJ Van den Bergh*, Financing and Group Litigation, in: M Tuil/L Visscher (eds), *New Trends in Financing Civil Litigation in Europe – A Legal, Empirical and Economic Analysis* (2010) 59.

⁵¹ See inter alia *HW Micklitz/A Stadler*, The Development of Collective Legal Action in Europe, especially in Germany (2006) 17 *European Business Law Review* 1473.

⁵² See *T Eisenberg/G Miller*, The Role of Opt-Outs and Objectors in Class Action Litigation: Theoretical and Empirical Issues, NYU Law and Economics Research Paper, No 04-004, SSRN: <www.ssrn.com/abstract/528147>.

⁵³ *Van den Bergh* (2013) 1 *Maastricht Journal* 12, 14.

An important design choice is between on the one hand freedom for individuals to join the group (a so called opt-in model) versus a model whereby in principle all are presumed to join the class unless they have shown not to be interested (an opt-out model).⁵⁴ Economists strongly favor opt-out systems as they lead to more participation and consequently better deterrence. Mandatory systems are also imaginable.

1 Class actions

In a class action usually an attorney acts as an entrepreneur and will represent the class. His interest is that he, after judging the merits of the case, makes a substantial upfront investment, hoping to collect a substantial fee out of a positive judgment or a settlement. In those situations the classic principal-agent problem arises, being that the interests of the agent (the attorney in this case) may not always coincide with the interests of the principals (the victims he represents).⁵⁵ A related issue is that a way of financing the claim still has to be found. Often attorneys representing a class will pre-finance the claim on the basis of a conditional or contingency fee agreement.

Such systems of lawyer remuneration entail dangers of distorted incentives. The financing may, for instance, have an adverse influence on the incentives of a lawyer to accept a settlement. It can generally be held that a shift to a result-based compensation system provides better incentives for a lawyer to accept a settlement. Under a result-based compensation system lawyers may have a greater propensity to settle since they will only continue to negotiate (or decide to litigate) when it is cost effective.⁵⁶ In theory a system whereby the lawyer is paid on an hourly basis has the reverse (undesirable) effect: lawyers may have incentives not to accept a reasonable settlement and hence to litigate too many cases. The latter could be controlled through legal ethics or through reputational sanctions. These reputational effects may, however, mostly work in the case of repeat players such as, for example, commercial clients rather than with individuals (like consumers) who are so-called ‘one-shotters’. There is ample empirical evidence of how the payment systems of lawyers affect incentives to settle especially in cases of group litigation. Various studies of Hensler have shown the dangers of so called collusive settlements. These collusive settlements would be mainly beneficial for the

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54 See on the differences *Keske/Renda/Van den Bergh* (fn 50) 60 f.

55 See *Keske/Renda/Van den Bergh* (fn 50) 64; *Tuil/Visscher* (fn 13) 177 and 185.

56 See *Faure/Fernhout/Philipsen* (fn 28) 37.

attorney (receiving high fee awards) but not for the consumers.⁵⁷ Well-known cases are those whereby the settlement provided victims with low-value coupons for price reductions on further purchases instead of damage payments whereas the attorneys fee was calculated on the basis of the total value of the coupons.⁵⁸ To some extent principal-agent problems may then arise that could endanger the efficiency of a settlement in collective action cases.

Other potential problems that emerge from the literature are the danger of non-meritorious suits being brought in order to extract an early settlement.⁵⁹ Plaintiffs would bring (non-meritorious) class actions, exercising pressures to settle (in order to avoid legal fees and reputational losses) as a result of which defendants would settle (even for high amounts) although the case may have no merits at all. Empirical evidence is overall inconclusive.

The benefits of group litigation are large since the system allows remedying rational apathy in the case of scattered losses and could thus add to deterrence and compensation. However, an important counter argument against class actions is that they would be substantially more costly than individual litigation since class actions would take considerably longer than other trials and would require more attention by the judge.⁶⁰ The empirical evidence on whether class actions are really more expensive than individual litigation seems to be inconclusive⁶¹ as a result of which it was proposed to conduct a cost benefit analysis of class actions.⁶² With a view to introducing safeguards to class actions, options include: (1) restoring control by the class members, (2) judicial review of the merits of the case, the terms of the settlement and the amount of the contingency fee and (3) auctions determining the lawyer to represent the class.⁶³

2 Representative actions

Another way to solve the collective action problem in cases of scattered harm is to grant a right to a representative organisation, such as an NGO or consumer

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⁵⁷ See *Hensler* (fn 25) 157 f.

⁵⁸ See *Keske/Renda/Van den Bergh* (fn 50) 65 and *D Hensler*, Class Actions Dilemmas: Pursuing Public Goals for Private Gain, Santa Monica, Rand Corporation (2000).

⁵⁹ See *Keske/Renda/Van den Bergh* (fn 50) 66.

⁶⁰ See *Keske/Renda/Van den Bergh* (fn 50) 63; see *Duggan* (fn 10) 48.

⁶¹ See on the US perspective *Hensler* (fn 25) 155–163.

⁶² See *Hensler* (fn 58).

⁶³ See *Keske/Renda/Van den Bergh* (fn 50) 67. *Van den Bergh* (2013) 1 Maastricht Journal 12.

organisation, to file a suit on behalf of the victims.⁶⁴ This, in fact, is more popular in Europe. One of the problems that could equally arise in this situation is again the principal-agent problem.⁶⁵ Questions can in some cases be asked about whether the association really acts to represent the interests of the victims in an adequate way.⁶⁶ This possible problem of a divergence of interests between the representative organisation and the consumer may especially be large in the situation (as is often the case in European Member States) that the consumer organisation is in fact a monopoly. Competition could better guarantee that the organisation acts to represent the victims in an adequate way. One also has to carefully differentiate between a consumer association financed by membership fees, and one by public funds. In addition to the possible divergence of interests a consumer organisation may also face financing problems. Again, some of the techniques discussed before, like conditional fees, could be used to guarantee that only meritorious suits are brought. If the organisation has to finance the suit just with the budget collected from membership fees, raising adequate funding may be a challenge.⁶⁷ Some designs of representative actions allow the representatives to keep part of the proceeds of the claim. This may be crucial to induce them to take up cases in the first place. A similar reasoning can be instituted for environmental associations.⁶⁸

Overall, joining claims in such a way is a powerful tool to overcome rational apathy, free-riding and funding problems. This aspect takes due note of the fact that the harm is widespread. Up to a certain harm limit, such an exercise makes economic sense. Again, in the case of very little harm, we may face additional obstacles. Is calculating and distributing very low damage compensation to a large group of consumers economically feasible? Can we expect to deter a wrongdoer with such a prospect? If consumers were harmed by very few Euros and had to contribute at least this to a collective action to get it back, they would not do it and the scheme would not provide viable deterrence options. Therefore, again after a short diversion to current EU policy, we will look at alternative remedies. Needless to say, we have seen how grouping claims leads to new and different

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⁶⁴ See all those representative actions by consumer organisations, *Keske/Renda/Van den Bergh* (fn 50) 67–72.

⁶⁵ In a way the chain is lengthened, *Schäfer* (2000) 9 EJLE 183, 195.

⁶⁶ See *Keske/Renda/Van den Bergh* (fn 50) 70 and *Tuil/Visscher* (fn 13) 186.

⁶⁷ Law and economics scholars indeed warn that consumer associations may misuse their enforcement powers for opportunistic reasons. See in that respect especially *Van den Bergh* (2013) 1 Maastricht Journal 12; but also *Schäfer* (2000) 9 EJLE 183.

⁶⁸ See *M Faure/M Mühl/N Philipsen*, Incentives, Costs and Benefits: A Law and Economics Analysis, in: M Faure/N Philipsen (eds), *Access to Justice in Environmental Matters* (2014) 38–40.

incentive problems that all need to be taken care of in an adequate design. Regarding the role of the judge recent behavioural research doubts whether judges have the possibility to adequately execute the ambitious tasks awarded to them within group litigation.⁶⁹

3 Current EU policy

There is European legislation enabling actions for injunctive relief by a number of competent bodies in cross-border situations.⁷⁰ Passing European legislation also for other contexts or remedies has been on the European agenda for a number of years. The recent Commission Recommendation⁷¹ regarding collective redress sets out a number of common European principles. This is the furthest the EU has come in the field of collective redress for damages. The recommendation applies broadly, to consumer policy and competition policy, and to any other policy area where it may be relevant, such as environmental law. Currently, the availability of collective procedures in the EU is still rather limited. An emphasis in Europe is put on representative actions. Importantly ‘representative action’ in the definition of the Commission’s Recommendation means ‘an action which is brought by a representative entity, an ad hoc certified entity or a public authority on behalf of and in the name of two or more natural or legal persons who claim to be exposed to the risk of suffering harm or to have been harmed in a mass harm situation whereas those persons are not parties to the proceedings’.⁷² Consequently it allows for any kind of representative.⁷³ As said, the status of the document is that of a ‘recommendation’. It is, therefore, not as such binding and Member States are left to experiment. The document, nevertheless, clearly signals a European consensus not to enable any kind of American class action, contingency fees or punitive damages for Europe.

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⁶⁹ For a detailed analysis see *A Biard, Judges and Mass Litigation. A (Behavioural) Law & Economics Perspective* (2014).

⁷⁰ Directive 2009/22/EC of the European Parliament and of the Council of 23 April 2009 on injunctions for the protection of consumers’ interests (Codified version) Text with EEA relevance, OJ L 110, 1.5.2009, 30–36.

⁷¹ Commission Recommendation of 11 June 2013 on common principles for collective redress mechanisms in the Member States for injunctions against and claims on damages caused by violations of EU rights, COM(2013). On the same date the Commission issued the Communication ‘Towards a European Horizontal Framework for Collective Redress’ (COM (2013) 401/2).

⁷² See II 3 (d) of the Recommendation.

⁷³ We will come back to this point when we talk about public authorities.

C The remedial perspective

A specific question is how wrongdoings can be deterred by creating a sufficient threat. In that respect, the problem remains that if only a few victims were to bring a suit, the threat posed by that lawsuit may be substantially lower than the actual social losses created by the perpetrator. To some extent, class actions or representative actions, just discussed, may remedy that problem, but that is only the case to the extent that it leads to wrongdoers being exposed to the full social cost of their activity. Given the limits of class actions and representative actions we discussed above, that may not always be the case. This merits looking at the remedial perspective in some more detail (independently of the initiator). One way to force a wrongdoer towards compliance is to use injunctions instead of monetary damages. However, this remedy is likely to lead to under-deterrence in many cases. The injunction could be aimed at remedying harm that has been caused in the past or preventing future harm from occurring. However, notwithstanding the major advantages of injunctions in forcing perpetrators towards compliance, the limitation is equally that injunctions do precisely no more than that: forcing perpetrators towards compliance. As a result, from an *ex ante* perspective, an injunction may not pose a sufficient threat if the only thing a perpetrator risks is to be forced back into compliance. Especially when the probability of either having to pay monetary damages or comply (as a result of an injunction) is less than 100%, private enforcement may not sufficiently deter. So that raises the question whether it is possible to increase the value at stake in private enforcement precisely in cases where there is a large probability of the wrongdoer escaping the clutches of the law.

Calculating very small damages and distributing them to all may not be feasible and, hence, not credible, from an administrative costs point of view. Alternative means are warranted. We will exemplify this solution by way of referring to ‘punitive damages’. Whenever compensation claims are not credible and injunctive relief does not go far enough, one could increase the deterrent effect by any means of making the sanction costlier. This could work by way of introducing fines, skimming-off procedures, punitive damages etc. Thus all these remedies share the characteristic that they pose a higher cost to the potential wrongdoer; they increase the stakes. This can happen in the context of individual or mass litigation. They are particularly crucial when the probability of being convicted via the other means is low.

1 Punitive damages

The imposition of punitive damages in private law has been a subject of debate for a long time. In contrast to public law, for which the sanctions are merely act-based,⁷⁴ private law in traditional theory is supported by so called ‘harm-based’ sanctions which aim to optimally allocate the cost of harm after the harm has taken place. The traditional goals implied in the damage rules are formulated as two principles: the compensation principle and the marginal costs principle. To be precise, the law should fully compensate the victim for his suffering and minimise total social costs by balancing ‘the incremental benefit of each precautionary activity to its incremental cost’.⁷⁵ In this sense, the traditional tort law story favours the compensation rule, implying that damages paid by an injurer should in theory be equal to the harm caused by his behaviour. By this rule, a potential injurer is thus made to internalise the cost of harm caused by his behaviour. A direct result is that a potential injurer will take proper measures to prevent the harm (level of care) and reduce the magnitude of participating in risky activities (activity level) under the threat of being held liable.⁷⁶ For instance, if the level of liability for a risky action is € 1000, which equals the magnitude of the potential harm caused by this action, a firm might pay up to € 1000 to prevent the risk or it will only engage in this activity when the potential benefit from it is higher than € 1000.

The traditional story of compensatory damages, however, only works in the situation when the injurer is found liable without doubt and the harm caused by his activity is definite. Academic studies have summarised some scenarios where compensatory damages cannot reach the expected goal and hence proposed a rule of punitive damages. For instance, according to Mitchell Polinsky and Steven Shavell, ‘punitive damages ordinarily should be awarded if, and only if, an injurer has a chance of escaping liability for the harm he causes.’⁷⁷ In real life, the

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⁷⁴ In the area of public law, for instance criminal law or administrative law, the legal sanction is mostly placed on wrongful actions. The purpose is to punish and to prevent wrong acts.

⁷⁵ *R Cooter*, Unity in Tort, Contract, and Property: The Model of Precaution (1985) 73 California Law Review 1 (These principles are based on common law rules. As is indicated by Prof Cooter, ‘Much of the common law is concerned with allocating the costs of harm, such as the harm caused by accidents, nuisances, breaches of contract, or governmental takings of private property’).

⁷⁶ *S Shavell*, Strict Liability versus Negligence (1980) 9 JLS 1, 1–2 (In tort law theory, the ‘level of care’ denotes the level of precaution that will be undertaken by a potential injurer for a potential victim. The ‘activity level’, indicates a party’s magnitude of engaging in particular activities).

⁷⁷ *AM Polinsky/S Shavell*, Punitive Damages: An Economic Analysis (1998) 111 Harvard Law Review (Harv L Rev) 869, 874.

difficulty of identifying the injurer, the complexity of the rules of evidence,⁷⁸ as well as the high cost of litigation, all increase the chance that an injurer may escape liability for harms for which he should take the responsibility. Take a web-based slander/libel case as an example. In order to obtain the right amount of compensation, a victim has to prove who is responsible for spreading the slander and the amount of harm suffered by him. However, in many cases involving slander on the electronic highway, identifying the injurer and measuring the harm might be costly and time-consuming or sometimes impossible. Moreover, in some cases, injurers might intentionally take some steps to avoid detection and liability, such as in the cartel resulting in higher prices for mobile phone use (our example B above). If the injurer tries to hide the fact of infringements on purpose, the possibility of holding him liable is even lower. Even if a victim has already identified the injurer and could demonstrate his loss, the high cost involved in litigation may still reduce his willingness to sue and this also increases the possibility that an injurer may escape liability for the harm caused by him.⁷⁹ As a result, the problem of under-deterrence is apparent. That is, compensatory damages that are equal to a victim's loss cannot provide potential injurers with sufficient incentives to take a proper level of care and a reasonable activity level. Actors are likely to take insufficient precautions against the potential harm or increasingly engage in a particular behaviour. Moreover, a systematic under-compensation problem is created because victims can hardly obtain sufficient damages that can fully cover the harm caused by the injurers. For the above problem, a possible solution is offsetting the low possibility of detection by increasing the amount of damages. To summarise, it is suggested that judges should grant punitive damages for the purpose of overcoming both the under-deterrence problem and the under-compensation problem that are caused by the traditional damage rule.⁸⁰

2 Current EU policy

Punitive damages were generally considered not acceptable in most EU Member States, although some scholars notice a slight inclination at least at the EU level

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⁷⁸ Normally, a plaintiff in a tort case has to prove the magnitude of the harm suffered by himself, the person who should be held responsible for the harm as well as the causal relationship between the harm and the defendant's behaviour. In many cases, more particularly in a negligence setting, a plaintiff has to prove the injurer's fault as well.

⁷⁹ See *Polinsky/Shavell* (1998) 111 Harv L Rev 869, 888.

⁸⁰ See *ibid*, 936.

towards the acceptance of punitive damages.⁸¹ We can add that the previously mentioned recommendation for matters of collective redress restates the opposition to punitive damages.⁸² Remedies with similar economic effects like fines are widely available, for instance, within competition law (by the national competition authorities and the European Commission alike).

D Public law enforcement as an alternative

So far we have looked at solutions in the context of private law enforcement. In particular the matter of the information asymmetry but also the remedial perspective leads us to investigating public law solutions also. The argument in favour of public enforcement is especially strong in cases of widespread losses where individuals lack an incentive to bring a lawsuit, the reasoning being similar to that of grouping claims. Public enforcement, moreover, may have the advantage that ex ante monitoring can be exercised and that, as a result, also where the probability of detection is low, violations could still be established and the agency has more investigative powers at its disposal during procedures. Public enforcement also has the possibility of imposing sanctions (administrative or criminal) which are often much higher than the monetary damages that would be imposed through private enforcement.

1 Administrative law 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 same is true if an individual reports to an Environmental Authority. The state is supposedly the best risk bearer because it has numerous possibilities for risk pooling. An agency can typically even act on its own motion, which bears a potential of curing the rational apathy problems that exist with individuals. Depending on the case, some form of reporting – with potential rational apathy problems – may be

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81 For a summary of the debate at EU level see *RC Meurkens*, Punitive Damages. The Civil Remedy in American Law. Lessons and Caveats for Continental Europe (2014) 256–262.

82 The section in the recommendation on punitive damages reads: ‘Prohibition of punitive damages: 31. The compensation awarded to natural or legal persons harmed in a mass harm situation should not exceed the compensation that would have been awarded, if the claim had been pursued by means of individual actions. In particular, punitive damages, leading to over-compensation in favour of the claimant party of the damage suffered, should be prohibited.’

necessary to make the authority aware of an infringement.⁸³ 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 warranted.⁸⁴ As said, such agencies have a number of investigative powers. If law infringements are difficult to discover, an agency's lower costs of information discovery can be useful.⁸⁵ When information becomes highly technical, a public authority might be better equipped to gather it.⁸⁶ 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.⁸⁷ 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.⁸⁸ 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.

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83 See *MG Faure*, Onbegrensd Toezicht?, in: WODC (ed), Toezicht op Markt en Mededinging (Justitiële Verkenningen) (2008) 100.

84 See *Faure/Ogus/Philipsen* (2009) 31 *Law and Policy* 161, 168–170.

85 See for consumer law and competition law: *Van den Bergh* (2013) 1 *Maastricht Journal* 12. 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 under-cover agents, see *IR Segal/MD Whinston*, Public vs. Private Enforcement of Antitrust Law: A Survey (2006) *Stanford Law and Economics Olin Working Paper* No 335, 6. They refer to antitrust cases.

86 See *S Shavell*, The Optimal Structure of Law Enforcement (1993) 36 *Journal of Law and Economics (JLE)* 255, 270.

87 See *Landes/Posner* (1975) *JLS* 1, 29. An example would be competition authorities that not only have more resources, but also wide investigate powers that an individual could not make use of. Also economies of scope can speak in favour of the involvement of a public authority, see *MJ Trebilcock*, Rethinking Consumer Protection Policy, in: CEF Rickett/TGW Telfer (eds), *International Perspectives on Consumers' Access to Justice* (2003) 84.

88 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 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.

In stark contrast to civil litigation the benefits for individuals involved in such a procedure usually do not include compensation.⁸⁹ Public agencies traditionally have remedies like injunctions, revocation of licenses or fines at their availability. Where an individual may be mainly interested in damages, he may lack incentives to report a wrong to a public authority. In particular, with a view to cases of very small and widespread harm, the compensation function to some extent takes a back seat and other motivations may prevail (and be economically desirable) – one example may be stopping environmental damage.

To ensure that only meritorious cases are being dealt with, 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 is said to be higher compared with criminal law enforcement, because the decision making process is less elaborate (see below).⁹⁰ 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.

According to definition, a public authority works in the public interest but those regulated could attempt to exercise influence over the public officials (referred to as capturing).⁹¹ Also, the costs of the administrative enforcement system may be substantial and depend on how many entities exist, the powers they have and the frequency with which they make use of such powers. Few studies exist that measure these costs accurately. Unlike with private enforcement, the main costs with public enforcement occur in the form of monitoring and detection, particularly, the use of investigative powers.⁹² Some of these costs are incurred even though no harm was inflicted, which also is different from private law enforcement. Then again, a public authority is generally not concerned with calculating and distributing damage.

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⁸⁹ However, in some cases the individual can use the outcome of the administrative law enforcement in a subsequent private lawsuit.

⁹⁰ See *N Garoupa/F Gomez-Pomar*, Harvard Law School John M. Olin Center for Law, Economics and Business Discussion Paper Series. Paper 308 2000, 5; *Faure/Ogus/Philipsen* (2009) 31 Law and Policy 161, 176.

⁹¹ *A Ogus*, Regulation: Legal Form and Economic Theory (1994) 57.

⁹² See *D Wittmann*, Prior Regulation Versus Post Liability: The Choice between Input and Output Monitoring (1977) 6 JLS 193, 207 ff; overall little empirical research has been done on regulatory agencies within consumer protection; see *S Meili*, Consumer Protection, in: P Cane/HM Kritzer (eds), *The Oxford Handbook of Empirical Legal Research* (2010) 186.

Note in addition that the group litigation perspective can be considered in that the public authority could represent a group of individuals in court.⁹³ The reasoning is similar to the above (section B); however, an important additional benefit is that more information can be generated if a public player is involved in group litigation thanks to its investigative powers.

2 Criminal law enforcement

Criminal law enforcement has potentially even more benefits than administrative enforcement, but potential costs as well. 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.⁹⁴ In order for criminal law enforcement to be triggered, an ‘initial suspicion’ 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.⁹⁵ As said, in the context of very small and widespread harm in particular, other motivations may be at play. Criminal procedural law involves an appeal structure, a standard of proof ‘beyond reasonable doubt’ and consideration of the mental element.⁹⁶ Because of the high standard of proof in criminal law, there is a lower probability of convicting the innocent.⁹⁷ Error costs depend on the accuracy of procedural law, and the more accurate the procedure is, the less often errors occur. In the context of the wrongdoers being companies, one needs to assure that personal liability systems are actually in place. Criminal law enforcement typically in-

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93 According to the European recommendation, any player – public or private – can be the group representative (see Section B.3).

94 See *Shavell* (1993) 36 JLE 255, 260.

95 See *Shavell* (1993) 36 JLE 255, 268.

96 See *R Bowles/MG Faure/N Garoupa*, The Scope of Criminal Law and Criminal Sanctions: An Economic View and Policy Implications (2008) 35 JLS 389, 405; *R Galbiati/N Garoupa*, Keeping Stigma out of Administrative Law: An Explanation of Consistent Beliefs (2007) 15 Supreme Court Economic Review (SCER) 273, 274; *KN Hylton/VS Khanna*, Toward an Economic Theory of Pro-Defendant Criminal Procedure, Discussion Paper No 318.3 (2001).

97 See *RA Posner*, An Economic Approach to Legal Procedure and Judicial Administration, in: F Parisi (ed), The Economic Structure of the Law: The Collected Economic Essays of Richard A. Posner (2000) 201, 410.

cludes more severe sanctions than administrative law enforcement.⁹⁸ High sanctions available in criminal law enforcement are also interesting for deterrence purposes.⁹⁹ 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.¹⁰⁰ Imprisonment is essential as a deterrent¹⁰¹ and is the desirable sanction when the probability of detection and conviction is low and the likelihood of defendants being judgment-proof is high.¹⁰²

The major advantage of the criminal law is consequently that it can also provide a sanction for judgment-proof defendants because it also allows the imposition of non-monetary sanctions. However, this advantage equally comes at a price. There is consensus that criminal law enforcement involves very high administrative costs because it includes an appeal structure that supports accuracy and avoidance of error costs.¹⁰³ Therefore, conviction costs are higher and sanctions, mainly imprisonment, are expensive.¹⁰⁴ Furthermore, additional resources are required when criminal law enforcement considers the mental state of the accused.¹⁰⁵

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98 See *Van den Bergh* (2013) 1 Maastricht Journal 12, 19.

99 On low probabilities of detection, see *Landes/Posner* (1975) JLS 1, 36. There is also the possibility of imposing fines that exceed the harm.

100 See *Bowles/Faure/Garoupa* (2008) 35 JLS 389, 405 (402); *S Shavell*, Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent (1985) Columbia Law Review (Colum L Rev) 1231, 1247; *S Shavell*, Foundations of Economic Analysis of Law (2004) 544.

101 See *M Polinsky/S Shavell*, Economic Analysis of Law (2005) 28. However, if a person is old or dying from a disease, imprisonment cannot fulfil its full purpose; see *Shavell*, Foundations (fn 100) 532. Here, for example, incapacitation measures are necessary and desirable.

102 See *Bowles/Faure/Garoupa* (2008) 35 JLS 389, 405.

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

104 See *Becker* (1968) 76 J Pol Econ 169, 180. Costs of imprisonment include expenditure for guards, supervisory personnel, buildings, food and so on; *Ogus* (fn 91) 45: 'The costs increase very sharply'. See also *Faure/Ogus/Philipsen* (2009) 31 Law and Policy 161, 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'.

105 See *Galbiati/Garoupa* (2007) 15 SCER 273, 274; *Garoupa/Gomez-Pomar* (fn 90) 4: An administrative agency neglects the mental states of an offender. Overall it should be left mainly as an underlying threat, according to *Ogus* (fn 91), concentrating on the relation between administrative law enforcement and criminal law enforcement.

3 Current EU policy

At European level, legislation on consumer law enforcement complements laws regarding substantive consumer law provisions for the first time on the basis of Regulation 2006/2004 on consumer protection cooperation (CPC Regulation).¹⁰⁶ The CPC Regulation follows a public law enforcement approach and creates an EU-wide network of national enforcement authorities with similar investigative and enforcement powers for certain collective intra-Community consumer law infringements. Outside of consumer law a stronger reliance on administrative or criminal law is prevalent: European competition law is enforced by public authorities (European Commission, national competition authorities) and private parties (competitors, suppliers, consumers).¹⁰⁷ As far as environmental law is concerned, the European Commission clearly has more faith in public enforcement and, more particularly, criminal law. Two Directives have been issued forcing the EU Member States to introduce criminal sanctions on the violation of national legislation implementing European environmental law.¹⁰⁸

E Hybrid models

So far we have discussed some advantages of the compensatory function of private enforcement and stressed that, especially in the case of dispersed losses, incentives may be diluted. Although some solutions to improve private enforcement were discussed, they all seem to have their limits and challenges as well. Their success is partly determined by how small the individual damage is and there is inter-dependence with the type of remedy available. Applying not only private but also public means with either administrative or criminal sanctions in the case of widespread damage seems warranted. The problem arises, however, that public law enforcement may serve the social goal of forcing the wrongdoer towards compliance, but it may not serve justice to the individual victim by providing compensation (generally and even where appropriate from an econom-

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106 Regulation (EC) No 2006/2004 of the European Parliament and of the Council of 27 October 2004 on cooperation between national authorities responsible for the enforcement of consumer protection laws (the Regulation on consumer protection cooperation) Text with EEA relevance, OJ L 364, 9.12.2004, 1–11.

107 See *Van den Bergh* (2013) 1 Maastricht Journal 12.

108 It concerns Directive 2008/99 of 19 November 2008 concerning environmental crime and Directive 2009/123/EC of 21 October 2009 amending Directive 2005/35/EC on ship-source pollution.

ic point of view). Expressing it in terms of incentives, an individual might not be motivated to report violations to the public authority if that could not lead to any damage compensation. The problem, more generally, upsets the second goal of tort law – that of victim compensation. That then raises the question of whether it is possible to develop ‘smart mixes’ between public and private law enforcement, using on the one hand the information advantages of public authorities with higher investigative powers and their ability to capture widespread low-value claims, and on the other hand ensuring that individuals who have suffered harm cooperate with the public enforcement system by setting the right incentives through the available (private law) remedies. Such a smart mix, or a complementarity between private and public law enforcement could, for instance, be created by also allowing compensation via public enforcement models.

1 In criminal law: *partie civile*

Possibilities exist in many legal systems to combine public law enforcement with private law claims. The economic justification for such a combination is obviously that the intervention of victims within public enforcement can enhance compliance with the regulatory regime. Some European legal systems allow private claims to formally join the criminal enforcement process. The advantage is that this enables the victim also to rely on evidence furnished through the public action.¹⁰⁹ Moreover, even where the victim was not allowed to formally join the criminal procedure, he could use a criminal conviction as evidence for the purpose of an independent private law action.¹¹⁰ The advantage of making optimal use of the potential combinations between private and public law enforcement is that it can lead to substantial savings in information and administrative costs for the victim (who can simply join the public enforcement) and hence to increased deterrence of wrongdoers and ensure compensation. Those benefits may be substantially larger than the additional costs of letting victims join the criminal procedure. It will mean that the judge will have to decide not only on the violation and the imposition of an appropriate sanction, but also on the private claim of the victim. This, however, saves on the costs of a separate private claim which the victim would otherwise have to bring.

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109 See *CHR Hodges*, Multi-Party Actions: A European Approach (2001) 11 *Duke Journal of Comparative and International Law* 321.

110 See *Faure/Ogus/Philipsen* (2009) 31 *Law and Policy* 161, 182.

2 Theoretical options in administrative law

When thinking of cases of small and widespread damage induced by rogue traders who go to great lengths to remain undetected, a smart mix with administrative law is also imaginable. Again, additional investigative powers enter the picture that impact upon the information asymmetry prevalent between claimant and defendant, and administrative procedural law is capable of reducing the individual's costs.¹¹¹ By incorporating private law aspects, compensation as a remedy could enter the enforcement response where feasible from an economic point of view. In terms of fine-tuning an enforcement response there is, consequently, also a potential for administrative law to enhance private law enforcement. Therefore, it is a fair question if the current differentiation between administrative and private law can still be fine-tuned. There are three options: first, the bodies could be more smoothly inter-related. This would mean that findings established in one could be used by the other (for example, information generated by the authority used in the courts for actions such as follow-on damage claims). Second, a civil judge's investigative powers could be increased or third, 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 procedure or the necessity to involve lawyers, may have to be changed likewise. Furthermore, administrative costs have to be kept within reasonable limits. In practice few such examples exist. One exception is the British Banking sector. The key sectoral regulator in the banking sector is the Financial Conduct Authority (FCA), concerned with rule-making, investigation and enforcement. This desired combination is possible via restitution orders that need to go via the courts (sec 382–4 Financial Services and Markets Act 2000 (FSMA)). They are available in the case of collective violations. Importantly, the investigative powers of the FCA can be made use of, such as access to documents, investigations regarding the amount of profits made, conduct or questions of distribution of compensation.¹¹² Special investigators may be appointed according to sec 67 or 168 FSMA. A second way to obtain compensation in the context of this public scheme is according to the Consumer Redress Scheme (sec 404(1) FSMA) that was introduced in 2010 by the FCA's predecessor.¹¹³

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111 *F Weber*, Assessing Existing Enforcement Mechanisms in Consumer Law – The Unavailability of an Allrounder (2011) 3 *Europarättslig tidskrift* (Swedish Journal of European Law, ERT) 536.

112 See The Enforcement Guide 01/04/2014, Section 11.

113 See also FCA Handbook.

If any such fine-tuning took place, criminal law should be reserved as a fall-back option given its higher administrative costs. On the other hand, one might argue that in countries where criminal cases regularly involve the assessment and granting of damage payments, an expansion of criminal law to grant compensation payments (on a regular basis) could be considered instead, as it involves fewer institutional changes for those particular countries.

Again the inter-relation is particularly interesting where damage claims are feasible. Such public private models can equally be discussed with a view to fines or skimming-off procedures when a claim for damages is no longer feasible – the context of *very* small and widespread harm. Obviously this section has just sketched the possibilities and has not dealt in detail with legal questions such as whether the standard of proof applied in the one proceeding suffices also for the other type of proceeding and the like.

3 Current EU policy

For some policy areas at European level, the European legislator suggests enforcement tools from different procedural fields. They interact to different degrees. By way of example, prominent in the competition law field, private enforcement was recently suggested to enhance the dominant public law enforcement approach with a newly enacted Directive on anti-trust damages actions.¹¹⁴ Article 3 sets forth that anyone who has suffered harm due to an infringement of competition law is entitled to full compensation. The Directive explicitly excludes any form of punitive damages.¹¹⁵ Special rules apply with a view to using the files of a competition authority in civil litigation.¹¹⁶ Article 17 (3) concerns the quantification of damages and is interesting in terms of procedural inter-relations:

Member States shall ensure that, in proceedings relating to an action for damages, a national competition authority may, upon request of a national court, assist that national court with respect to the determination of the quantum of damages where that national competition authority considers such assistance to be appropriate.

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114 Directive 2014/104/EU of the European Parliament and of the Council of 26 November 2014 on certain rules governing actions for damages under national law for infringements of the competition law provisions of the Member States and of the European Union (OJ L 349, 5.12.2014, 1–19) – 2013/0185 (COD). ECJ case law had started this development more than a decade ago.

115 See art 2(3) of the Directive.

116 See arts 5–7.

This shows the relevance of thinking about the links between different procedures.

IV Conclusions

The limited scope of this contribution allowed us only to sketch the important means that improve the deterrence and compensation function of tort law where individual damage claims are not feasible from the start because of distorted incentives. We have, in particular, sought to stress that one needs to differentiate between cases of small and widespread damage where the deterrence and compensation can be achieved and cases of very small and widespread harm where compensation is neither feasible nor credible and the focus should, therefore, be on the deterrence function.

When it simply comes to improving the risk ratio for individual compensation claims in the civil court, various funding and insurance functions have been mentioned. In addition to looking for solutions within the court, we illustrated how out-of-court dispute resolution in various forms can be beneficial in capturing claims of small value.

Next, we considered the attribute ‘widespread’ and, therefore, looked at any solution that would involve grouping claims, thereby leading to cost-reductions for the individual. Models of class actions and representative actions alike show strengths but display other weaknesses in terms of their incentive structures. The remedial perspective is crucial to design law enforcement in a way that it ensures the deterrence function also for cases of very small harm.

The enforcement of public law is carried out in a way similar to that of grouping claims, since the matter is dealt with in one go, and an individual’s monetary contribution is reduced. A particular focus was on additional investigative powers entering the picture, able to cure information asymmetries as to the nature of wrongs and wrongdoers. New sanctions, likewise, became available.

Inter-twining the two dimensions may generate benefits. A particular focus was on the compensation function. As mentioned, this is only true for the category of cases where the feasibility is still given. For cases of very small and widespread harm, fine-tuning the two dimensions with a view to other remedies than compensation can be cost-effective.

The final solution as of now is still pending. Initiatives in different countries and at European level are ongoing. Clearly, whether a measure can successfully be implemented, in a low-cost way, depends upon the country path – this may be another parameter for deciding which option to prefer over another.

Insights into the effect of the different remedies, such as when compensating individuals in cases of small and widespread harm is feasible, were formulated on the basis of rational choice theory. Behavioural insights on how people really react to different available remedies – victims in terms of initiating claims and tortfeasors in terms of being induced to compliant behaviour – would be highly relevant to refine such conclusions.