

## THE PREVENTIVE FUNCTION OF COLLECTIVE ACTIONS FOR DAMAGES IN CONSUMER LAW

*Roger Van den Bergh\**

*Louis Visscher\*\**

### Abstract

From a deterrence perspective, private enforcement of consumer law can be insufficient for several reasons. Individual consumers may find it too costly to start a lawsuit ('rational apathy') or they may not even know that an infringement has occurred ('information asymmetry'). If public enforcement is not available, or if the budget of public authorities is limited and used for other purposes, the problem of under-enforcement will persist. Collective actions may be able to mitigate these problems. If many consumers can join their claims, the costs per claim decrease so that the rational apathy problem might be overcome. If consumer associations have standing, they might be able to acquire better information regarding infringements than individual consumers are able to do. However, collective actions pose problems of their own. The leading plaintiff or the organisation issuing the collective action could try to advance its own interests, rather than furthering overall consumer interests. Moreover, a large-scale lawsuit might harm the reputation of the defendant and thus create the possibility of 'frivolous suits'. The paper discusses a number of possibilities to overcome these problems. Ultimately, private and public enforcement will need to co-exist, since collective actions are not a perfect instrument to achieve optimal deterrence.

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\* Dr. Roger Van den Bergh is Professor of Law and Economics and Director of the Rotterdam Institute of Law and Economics (RILE), School of Law, Erasmus University Rotterdam.

\*\* Dr. Louis Visscher is Assistant Professor of Law and Economics, Rotterdam Institute of Law and Economics (RILE), School of Law, Erasmus University Rotterdam.

## 1 Introduction

An extensive body of consumer protection laws was enacted in European countries in the 1980s and '90s.<sup>1</sup> Large parts of consumer law have been harmonised by European regulations and directives.<sup>2</sup> Many commentators agree that the existing rules of substantive law provide adequate protection to consumers active in the marketplace. Problems are encountered mainly in the field of ensuring compliance with consumer protection laws; a general criticism is that these laws are insufficiently enforced.<sup>3</sup> Even though one may disagree with the first view, in particular when consumer protection rules are analysed through the lenses of economic analysis of law,<sup>4</sup> lack of enforcement does indeed currently seem to be the major challenge for improving consumer protection in European countries.

There are many reasons for the insufficient enforcement of consumer rights, particularly in cases of harm inflicted upon consumers in general. Firstly, private enforcement can fail because individual claims are costly, time consuming and risky, due to their uncertain results.<sup>5</sup> Moreover, the remedies awarded in the case of violation of consumer rights could be inadequate.<sup>6</sup> Injunctive actions may not be sufficient to deter conduct harming consumers<sup>7</sup> and damage awards can remain under-compensatory. Secondly, until recently public enforcement of consumer protection laws

<sup>1</sup> See S. Weatherill, *EC Consumer Law and Policy* (Cheltenham: Edward Elgar 2005).

<sup>2</sup> An overview of the 'consumer acquis' is given in the annex of Regulation 2006/2004, OJ L 364, 9.12.2004, at 11. To this list must be added Directive 2005/29/EC on unfair business-to-consumer practices (OJ L 149, 11.6.2005, at 22-39).

<sup>3</sup> See S. Deutch, 'Consumer Class Actions: Are They a Solution for Enforcing Consumer Rights? The Israeli Model', 27 *Journal of Consumer Policy* 179 (2004) and the contributions in W. van Boom and M. Loos, *Collective Enforcement of Consumer Law; Securing Compliance in Europe through Private Group Action and Public Authority Intervention* (Groningen: Europa Law Publishing 2007).

<sup>4</sup> For a summary of the most important criticisms, see R.J. Van den Bergh, 'Wer schützt die europäischen Verbraucher vor dem Brüsseler Verbraucherschutz? Zu den möglichen adversen Effekten der europäischen Richtlinien zum Schutze des Verbrauchers', in C. Ott und H.-B. Schaefer (eds.) *Effiziente Verhaltenssteuerung und Kooperation im Zivilrecht* (Tübingen: Mohr Siebeck 1997) 77-102.

<sup>5</sup> S. Deutch, above n. 3 at 180.

<sup>6</sup> W. D. Slawson 'Mass Contracts: Lawful Fraud in California', 48 *Southern California Law Review* (1974) 1 at 6.

<sup>7</sup> H-W. Micklitz and A. Stadler 'The Development of Collective Legal Actions in Europe, especially in German Civil Procedure', 17 *European Business Law Review* 1473 (2006) at 1475.

was not available in a number of European countries.<sup>8</sup> Regulation 2006/2004 has forced EU member states to establish public enforcement authorities for ensuring that cross-border infringements of consumer protection laws will be adequately sanctioned. But even the combined use of individual law suits and public enforcement may still fall short of ensuring an adequate level of enforcement of consumer protection laws. Public authorities face budget constraints and government priority considerations may divert resources to other enforcement activities. Individual claims could remain unattractive because the private costs of initiating legal proceedings tend to exceed the expected private benefits. In addition, individual victims might prefer to take a free ride on the efforts of those consumers who decide to act as plaintiffs. The combined effect of rational apathy and free-riding will be a sub-optimal level of enforcement.

Several possibilities exist to enhance the enforcement of consumer protection laws. A first option is the institution of a test case procedure. On request of parties or by decision of the court, the common issues of several claims can be identified and decided in a single trial. Such procedures are available in Germany, Austria and the United Kingdom; they are not discussed in this paper.<sup>9</sup> A second option is to create the possibility of collective action. A particular form of collective action, the 'American style' class action, has been criticized because it puts a large burden on courts<sup>10</sup> and could create scope for frivolous claims. In particular, the attorney acting as the class representative may bring an unfounded claim to induce the defendant company to accept a settlement out of court. For a bona fide large firm, the latter can be more advantageous than paying the costs of a prolonged and expensive litigation. Class actions have been criticised also for other reasons, which are not inherent in this particular enforcement mechanism, but characteristic of US law. Rather than the class action in itself, some traits of the American legal system seem to cause major problems; they include contingency fees, punitive damages and jury bias. Contingency fees might be an appropriate way of financing the costs of a collective action but are often seen as contrary to the ethical rules of the

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<sup>8</sup> Conversely, public enforcement has been the dominant enforcement mechanism in the field of competition law. See R. J. Van den Bergh and P.D. Camesasca, *European Competition Law and Economics. A Comparative Perspective* (London: Sweet & Maxwell 2006, 2<sup>nd</sup> ed.) at 325.

<sup>9</sup> See for more information: J. Stuyck et al., *An Analysis and Evaluation of Alternative Means of Consumer Redress other than Redress through Ordinary Proceedings*, Final Report Study for the European Commission (2007) [http://ec.europa.eu/consumers/redress/reports\\_studies/index\\_en.htm](http://ec.europa.eu/consumers/redress/reports_studies/index_en.htm).

<sup>10</sup> M. Handler 'The Shift from Substantive to Procedural Innovations in Antitrust Suits - The Twenty-Third Annual Antitrust Review', 71 *Columbia Law Review* (1971) 1 at 7.

legal profession.<sup>11</sup> Punitive damages are criticised because they lead to overcompensation, even though they may be an effective method to cope with the risk of under-enforcement due to the low probability of detecting infringements. Finally, the US jury system could create a bias, to the detriment of large commercial enterprises, and lead to the award of enormous compensation sums.

Even though the above criticisms should be taken seriously, one must avoid throwing the baby out with the bathwater. The challenge is to design collective actions in such a way that the problems of under-enforcement of consumer rights are solved, while at the same time the potential disadvantages of new enforcement mechanisms are minimized. To that end one should look at alternatives to the ‘American style’ class action. These can be either collective actions initiated by individual consumers but with different (‘European’) characteristics or collective actions initiated by representative bodies, such as consumer associations. Hereinafter the latter form of collective actions is discussed under the heading ‘representative actions’.

The structure of this paper is as follows. Section 2 will provide a brief overview of two different models of collective actions: collective claims initiated by an individual person or group of persons in the name of a group of harmed consumers, and representative actions initiated by consumer associations in the collective interests of consumers. A further distinction will be made depending on whether and how individual consumers decide to adhere to a collective claim (opt-in or opt-out). Sections 3 and 4 will then tackle the main research question of this paper: How should collective actions be designed to maximise their net advantages? To answer this question, there should be clarity about the objectives to be achieved by collective actions for damages. Discussions on public or private enforcement are often obscured by the lack of a clear definition of the goals. Both efficiency (deterrence of infringements of consumer protection laws) and corrective justice (compensation of harm inflicted upon consumers) occupy a prominent place in the debate on the goals of law enforcement. From the perspective of economic efficiency, the major goal of damages claims is to deter welfare-reducing infringements of consumer protection

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<sup>11</sup> It is argued that contingency fees put the independence of the lawyers in jeopardy, since they get a personal interest in the case that may diverge from the clients’ interests. In the Law and Economics literature, the reply to this traditional criticism is that principal-agent problems also exist under hourly fees but manifest themselves in a different way (see F.H. Stephen and J.H. Love ‘Regulation of the Legal Profession’, in B. Bouckaert and G. De Geest (eds.), *Encyclopedia of Law and Economics III*, (Cheltenham: Edward Elgar 2000) 986 at 1002). With respect to the opinions on the impact of contingency fees on the risks of early settlements and unmeritorious cases, see below in sections 4.1.-4.3.

laws. Therefore, the central question of this paper is whether collective actions may contribute to prevent infringements of consumer law. The goal of compensation (corrective justice) is discussed only so far as it is instrumental to achieve the deterrence goal, by increasing the size of the expected costs of law infringements. In section 3 we will explain the benefits of collective actions. The main benefits seem to be the possibilities of reducing the existing information asymmetry and solving the rational apathy problem on the side of individual consumers. In section 4 we will address the main criticisms that have been forwarded against a widespread use of collective actions. These include: the costs imposed on courts, problems connected with the way in which collective actions are financed, the risk of frivolous suits and opportunistic behaviour of representative bodies. We will show that both the expected size of the potential benefits and the seriousness of the potential disadvantages vary according to the model of collective action which has been adopted. Finally, section 5 will summarise the main results of the paper and suggest a number of questions for further research.

## 2 Types of collective action

Collective actions may be classified in different categories. Depending on who the plaintiff is, collective actions can be divided into two types: i) proceedings initiated by an individual claimant (or group of claimants) in the name of a group of consumers; ii) proceedings initiated by a body representing consumer interests, such as consumer associations which have received legal standing.<sup>12</sup> A subsequent differentiation can be made on the basis of the possibilities of consumers to either opt in or opt out. Under the first model, individuals, after having been appropriately informed about the infringement, must express the wish to participate in the proceedings. Under the latter model, individuals must assert their wish not to be bound by the outcome of the litigation. In principle, opting in or opting out is possible at all stages of the legal proceedings, for example before the trial has started or after a settlement has been reached. Individual decisions to opt in or opt out are not part of so-called mandatory class actions, which can be found in the US. Another distinction can be made, depending on the sanctions that can be imposed by courts. Many European countries allow actions for injunctive

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<sup>12</sup> Similar distinctions are made by S. Deutch, above n. 3 and K. Viitanen, 'Enforcement of Consumers' Collective Interests by Regulatory Agencies in the Nordic countries' in: W. van Boom and M. Loos (eds.) *Collective Consumer Interests and How they Are Served Best in Europe: Legal aspects and policy issues on the border between private law and public policy* (Groningen: Europa Law Publishing (forthcoming June 2007)).

relief brought by consumer associations in particular fields of law (for example, in the area of fair trade practices). Conversely, only very few European countries presently have types of collective actions for damages. This paper discusses only the latter type of collective actions.

The best-known example of a private collective action for damages is the US class action. In this model, an individual consumer or a number of consumers with a common interest can file claims to obtain redress for the entire 'class' of consumers in one single action. Rule 23 of the Federal Rules of Civil Procedure enumerates four prerequisites for class actions: i) the number of members of the group must be very large so that joinder of all members is impracticable, ii) there are questions of law or fact common to all members of the class, iii) the claims of the representative parties are typical of the claims of the class, and iv) the representative parties will fairly and adequately protect the interests of the members of the class. Next, Rule 23 delineates three major categories suitable for class treatment. These are: i) the risk of inconsistent or varying adjudications with respect to individual members of the class or adjudications with respect to individual members which would as a practical matter be dispositive of the interests of individuals not parties in the legal proceedings, ii) the fact that the defendant has acted or refused to act on grounds generally applicable to the class, and iii) the finding of the court that the questions of law or fact common to the class predominate over any questions affecting only individual members of the class and that a class action is the best method for a fair and efficient adjudication of the controversy. In American class actions, the main remedy is the award of damages which compensate the members of the class for their losses. Often, very large damage awards are granted; enormous compensations are largely due to the jury system and the possibility of granting statutory treble damages and punitive damages.

In European countries, rules of procedural law do not generally allow a single individual or a number of individuals to sue without the prior consent of each member of the affected group. Many EU member states (including the United Kingdom, France, Germany, Belgium, the Netherlands and Sweden) have granted standing to private associations or public bodies, which can bring representative actions. However, these rights are mostly limited to obtain injunctive relief and sometimes disgorgement of unlawfully obtained profits (Germany). The vast majority of EU member states presently have no collective action for damages at all. However, some countries (including the United Kingdom, Sweden, Spain, Portugal and Lithuania) have adopted legislation in the field of procedural law to increase the effectiveness of private enforcement. This has led to the creation of new enforcement mechanisms which are somewhat similar to US-style class action, even though the discussion below will make it clear that they do not have the characteristics typical of the American legal procedure. A solution

closer to the American class action has been adopted in the Netherlands. Given its specific characteristics, it will be discussed in somewhat greater detail. Moreover, in other countries (Belgium, Finland,<sup>13</sup> Denmark and Italy) proposals concerning the introduction of a representative collective action for damages have been submitted.

In the United Kingdom, collective actions for damages are available. In addition, specified bodies (allowed by the Foreign Secretary) are permitted to bring representative follow-on actions for infringement of competition law before the Competition Appeal Tribunal.<sup>14</sup> In Sweden, collective actions for claiming compensation have been possible since the enactment of the Group Proceedings Act in 2003. Group actions are possible if they fulfil the general requirement that the facts are identical and that it is sensible to decide the disputes in a single trial. Collective actions can be initiated both by private individuals and organisations protecting citizens' interests or a public authority, such as the Consumer Ombudsman. An opt-in scheme has been chosen to form the group; as a consequence, only individuals who have adhered will be affected by the judgment.<sup>15</sup> After three years of experience, 6 out of 7 cases were initiated by private parties.<sup>16</sup>

According to the Dutch Civil Code, a foundation or association with full legal capacity can institute an action intended to protect similar interests of other persons to the extent that its articles promote such interests. The organisation has no standing if, in the given circumstances, it has not made sufficient attempts to achieve the objective of the action through consultation with the defendant. The organisations can sue both for an injunction and for damages regarding losses of the organisation itself, but not for compensatory damages regarding losses of the members of the group. The assessment of damages therefore has to be carried out in individual procedures. However, the collective action can result in a declaratory decision regarding the unlawfulness of the defendants' behaviour, which can be used in the individual procedures. Furthermore, the individual plaintiffs can authorize the organisation to collect the compensatory damages. This resembles a collective damages action, although it still has to be carried out in the name

<sup>13</sup> The proposal has met with strong opposition from business pressure groups. See K. Viitanen, above n. 12.

<sup>14</sup> Art. 47(B) of the Competition Act 1998. See Office of Fair Trading, *Private Actions in Competition Law: Effective Redress for Consumers and Business* (2007). <[http://www.oft.gov.uk/shared\\_oftr/reports/comp\\_policy/oft916.pdf](http://www.oft.gov.uk/shared_oftr/reports/comp_policy/oft916.pdf)>

<sup>15</sup> K. Viitanen, above n. 12.

<sup>16</sup> P.H. Lindblom and K. Norback *The Swedish Group Proceedings Act* (2006) 191 at 197.

<[http://www.bmelv.de/nn\\_754188/SharedDocs/downloads/02erbraucherschutz/Markt/Verbraucherrechtstage/26-Nordback,templateId=raw,property=publicationFile.pdf/26-Nordback.pdf](http://www.bmelv.de/nn_754188/SharedDocs/downloads/02erbraucherschutz/Markt/Verbraucherrechtstage/26-Nordback,templateId=raw,property=publicationFile.pdf/26-Nordback.pdf)>.

of all individual plaintiffs. If not all plaintiffs are traceable or if more plaintiffs are likely to turn up in the future, these solutions are inadequate.

In July 2005 the latter problem led to a reform of the Dutch Civil Code. A defendant who has entered into a contract regarding the compensation of damages with a foundation or association possessing full legal capacity can request (jointly with the foundation or association) that the contract be declared binding by the court upon persons to whom the damage has been caused.<sup>17</sup> The contract has to include a description of the group(s) of persons in whose favour the contract has been entered into, the number of persons belonging to this group, the compensation awarded to these persons (based on the group they belong to, i.e. damage scheduling) and the conditions with which these persons must comply to be eligible for compensation. Before it can declare the contract binding, the court has to assess the reasonableness of the amounts, the way in which the compensation can be received, whether the foundation or association is truly representative of consumers' interests and the financial security posed. If the contract is declared binding, victims will receive the agreed amount and they will be bound to the contract as if they had entered into it themselves. Victims who do not want to be bound by the contract (to try to collect complete damages in an individual procedure, for example) can opt out within a period of at least three months after a public announcement of the intended declaration.

### 3 Benefits of collective actions

Law and Economics literature provides arguments why private enforcement is sub-optimal to achieve the deterrence goal. Collective actions for damages are a potential remedy to the deficiencies of private enforcement by individual parties. These insights will be further explained in this section of the paper. Firstly, the main economic reasons why private enforcement is sub-optimal will be highlighted. In the literature, these arguments often lead

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<sup>17</sup> According to the Dutch legislator, in many US cases of mass damages the parties involved first reach a settlement and subsequently enter into a damages class action to ask the court to declare the settlement binding. The legislator therefore opted for the system of making a settlement contract binding, instead of introducing class actions for damages. In legal literature, it is argued that it is exactly the threat of the class action that might induce tortfeasors to settle in the first place. It therefore remains to be seen if the Dutch system is able to provide a well-functioning solution for mass damages cases, now that it relies on the cooperation of the defendant. In the Dutch DES-case, the settlement indeed was declared binding, see *Gerechtshof Amsterdam*, June 1 2006, *Nederlandse Jurisprudentie* 2006,461.



to the conclusion that public enforcement is necessary. However, before drawing this conclusion, one should investigate whether the problem of under-enforcement can be cured by improving the deterrent effect of private actions. Secondly, the economic benefits of collective actions will be explained. A good understanding of these benefits is necessary to see why, how and to what extent collective actions may cure the shortcomings of private enforcement by individual parties. It will be made clear throughout the analysis below that the achievement of better deterrence depends on the type of collective action (either initiated by individual parties or a representative body) and the specific design and modalities of collective actions (for example, the choice between an opt-out or opt-in scheme).

### **3.1 The shortcomings of private enforcement by individual parties**

To enable a better understanding of the shortcomings of private enforcement of consumer law, a brief comparison with the ongoing discussion on the desirability of increased private enforcement of competition law is useful. This debate has revealed three main reasons why private enforcement may be sub-optimal: lack of information, rational apathy and free-riding. Firstly, one cannot rely only on private parties for discovering and proving infringements of competition law. Even though information advantages generally support private enforcement (for example, in the case of liability suffered by a single individual based on tort law)<sup>18</sup>, such benefits may not exist in the field of competition law. In cases of hard-core cartels (such as price-fixing), most consumers do not even realize that they have been harmed. Secondly, in cases of infringement of competition law, interests of individual consumers diverge from the general interest. Private parties will initiate proceedings only if the private benefits of doing so are higher than the private costs. In the field of competition law, this private cost-benefit calculus has no systematic relation with the social costs and benefits. The social costs also comprise the harm suffered by consumers who do not sue<sup>19</sup>

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<sup>18</sup> S. Shavell 'The Optimal Structure of Law Enforcement', 36 *The Journal of Law and Economics* 255 (1993) at 267.

<sup>19</sup> It is well-known from price theory that monopoly creates two problems: (1) consumers have to pay more for the product, since the monopolist may charge a super-competitive price (price effect), and (2) consumers may purchase less of the product, even though additional purchases would be utility maximizing for them (allocation effect). The price effect of monopoly is a mere distribution from the producer to the consumer. However, the allocation effect causes a 'deadweight loss', which is not captured by the monopolist. Cartels and firms enjoying a dominant position cause deadweight losses, similar to the allocative efficiency of monopoly. To achieve optimal deterrence, these losses should be compensated to force the firms involved to internalize the negative welfare effects of their behaviour.

and other losses (rent-seeking)<sup>20</sup> that cannot be attributed to individual consumers. Even though it may be beneficial to society, individual consumers will not initiate enforcement actions, since potential plaintiffs are driven only by private gain, which could be lower than the expenses of their claims. From their point of view, not bringing any claim is perfectly rational; this problem is generally known as ‘rational apathy’. Finally, a system of private enforcement creates a free-riding problem. Every consumer who is a victim of an antitrust infringement has an interest to leave the enforcement efforts to other consumers, so that profits can be obtained without having to spend own resources. The free-riding problem will reduce the number of private actions below the level of enforcement that would be socially optimal.

In the field of consumer law, one cannot rely only on private actions to achieve an optimal level of enforcement either. The reasons are similar to those which apply in the field of competition law. Firstly, individual consumers may lack information on infringements of consumer protection laws. It can be difficult for individual consumers to recognize poor quality in markets characterized by serious information asymmetries. Examples include unsound investment advice by a financial consultant and non-transparent price calculations. It is also very difficult for consumers to assess whether manufacturers have obeyed safety regulations. Due to this information asymmetry, consumers may not start a lawsuit, even if the product they bought was defective. Consumers will often remain unaware of infringements before harm has occurred. For example, it could be very costly to check whether statements in advertisements are true or false. Also standard form contracts are usually signed without a prior reading of the contract terms, since the opportunity costs of time exceed the expected benefits from discovering harsh clauses.<sup>21</sup>

Secondly, there is a discrepancy between the private cost-benefit calculus of enforcement and the net social benefits. The social loss consists of the overall quality deterioration in markets plagued by information asymmetries. This social loss exceeds the private loss. If consumers have inadequate information to be able to distinguish beforehand between high-quality and low-quality products, while sellers do, then a case can be made for public enforcement. After all, consumers are only willing to pay a price based on the average quality, because they cannot assess the quality of any

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<sup>20</sup> These are the costs incurred to obtain and preserve a monopoly position. These costs are a pure welfare loss that must be added to the deadweight loss of monopoly.

<sup>21</sup> G. De Geest, ‘The Signing-Without-Reading Problem: An Analysis of the European Directive on Unfair Contract Terms’, in H.-B. Schäfer and H.-J. Lwowski (eds.), *Konsequenzen wirtschaftsrechtlicher Normen* (Wiesbaden: Deutsche Universitäts-Verlag 2002) 214.

particular product. High-quality products will be withdrawn from the market because the seller is not willing to accept only an average price. This withdrawal reduces the average quality remaining on the market, and consumers lower the price they are willing to pay accordingly. This process of ‘adverse selection’ continues until only products of the lowest quality are offered for sale.<sup>22</sup> This problem appears in markets for second-hand products and in markets for consumer goods that are not bought regularly (restaurant services in tourist destinations, audio equipment) or the quality of which is difficult to assess (standard terms & conditions in contracts, professional services). To some extent, the market itself may cure these problems through the desire to build and maintain a good reputation. Trademarks and (honest) advertising may signal quality.<sup>23</sup> However, consumer protection laws will be necessary to guarantee the quality of both experience goods, which are not regularly bought, and credence goods, the quality of which cannot be assessed by buyers. The social benefits of enforcement consist of increased overall quality of consumer goods. The private benefits are much smaller and only comprise the increase in quality of the products that the individual consumer buys. Therefore, consumers suffer from rational apathy and the private incentive to sue is insufficient from a social point of view.

Incentives to file individual suits will be too low if the loss consists of trifling damage; the costs of the lawsuit may then even exceed the expected compensation.<sup>24</sup> An example is product liability. Product-related losses can have a diffuse character: many individual consumers suffer a relatively small loss but the total social losses are substantial. This could lead to the situation that no individual plaintiff will file a suit because his private costs are higher than the expected private benefits.<sup>25</sup> However, given the large overall losses, it is desirable that consumers sue because this will induce the manufacturer to avoid those losses.

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<sup>22</sup> G.A. Akerlof ‘The Market for “Lemons”: Quality Uncertainty and the Market Mechanism’, 84 *Quarterly Journal of Economics* 488 (1970).

<sup>23</sup> P. Nelson ‘Advertising as Information’, 82 *Journal of Political Economy* 729 (1974).

<sup>24</sup> See W. H. van Boom, *Efficacious Enforcement in Contract and Tort* (Den Haag: Boom Juridische uitgevers 2006) at 17-18.

<sup>25</sup> The franchise in the European Directive on Products Liability intensifies the problem, because it bars claims on the basis of the Directive in case there is only property loss that does not exceed €500. Furthermore, the fact that much of the losses are covered by social and/or private insurance might strengthen the rational apathy with the consumers, even in cases where the individual loss might be substantial. This problem will be mitigated by the recourse claims that the insurance companies might start due to subrogation clauses in the insurance contracts. However, given that recourse claims are expensive, insurance companies might refrain from them in cases of relatively low losses, so that the problem will not be fully solved.

Finally, the free-rider problem hinders adequate enforcement of consumer protection rules. Every individual victim prefers other victims to sue the injurer, so that these others will incur costs and run the risk of losing the trial. If the plaintiff(s) win(s), victims who were not involved in the trial might benefit from the outcome of the trial all the same. This is clearest in cases where the plaintiff(s) has sued for an injunction or some kind of reform (e.g. improved product safety requirements). However, the free-rider problem is also present in cases where the plaintiff(s) have sued for damages. If legal and/or factual questions have been answered in the trial, the costs for other victims to start a case of their own will be lower. If all (or too many) victims behave as a free rider, there will be no lawsuit to start with and consumer protection rules will not be enforced.

### **3.2 Collective action as a remedy for the shortcomings of private enforcement**

Public enforcement may be advanced as a remedy to the problems discussed above. Public enforcement agencies may be better at discovering infringements, since they have investigative powers at their disposal. Moreover, they should have better incentives to bring claims since they have to protect the broader public interest rather than the dispersed small interests of individual consumers. However, some authors have argued that before resorting to public enforcement, possibilities to improve the efficacy of private enforcement should first be examined.<sup>26</sup> In the latter view, adaptations of the institutional legal framework for private enforcement might overcome the inefficiencies described above.

The case for a 'creative adaptation' of private enforcement procedures can also be made from an efficiency perspective, focusing on deterrence. If collective actions lead to a higher 'willingness to sue',<sup>27</sup> the

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<sup>26</sup> W.H. van Boom, above n. 24.

<sup>27</sup> This is ultimately an empirical question. Results of Euro-barometer surveys provide some anecdotal evidence that consumers may be more willing to sue if collective actions are possible. According to the survey conducted in 2004, respectively 2006, 67 respectively 77 per cent of European Union citizens will be more willing to defend their rights before a court if they can join with other consumers who complain about the same issue. The European consumer organisation BEUC therefore asserts that collective actions are particularly suitable to obtain compensation for damages where a large number of consumers are involved, and that, if handled individually, such claims will never be brought to court by the victims.' See C. Hodges 'Competition Enforcement, Regulation and Civil Justice: What is the Case?', 43 *Common Market Law Review* 1381 (2006) at 1387.

wrongdoer will be confronted with a sanction that better reflects the real losses inflicted on consumers in general. This is particularly important when the sanction imposed in public enforcement proceedings (a mere injunction or a fine which does not equal the harm caused) is lower than the total social costs. Well-designed collective actions may lead to better internalisation of the negative externalities flowing from infringements of consumer protection laws, and thus contribute to achieving the deterrence goal. Also the fact that more victims may be willing to bring suit, if they can share risks and expenses, will provide a better picture of the total losses that are actually caused by the wrongdoer. This size of the losses will be the starting point for determining damages so that future violations are deterred by forcing the law infringer to internalise the externalities caused.

The question thus arises whether collective actions may overcome (most of) the aforementioned problems. Firstly, it should be investigated to what extent a collective action can cure the information deficiencies with respect to law infringements. Secondly, it must be examined whether and, if so, how collective actions can solve the rational apathy problem. Finally, the type of collective action which best overcomes the free-riding problem should be chosen.

### **3.2.1 Collective actions as a remedy for information deficiencies**

There are several ways in which collective actions can solve, or at least diminish, information deficiencies. In this respect, we must distinguish between collective actions *sensu stricto* and representative actions. Under opt-in collective actions, consumers must be appropriately notified about the occurrence of any infringement that has caused them harm. Economically speaking, the value of the information provided is higher than the costs of the notification if it incites consumers to initiate a group action to recover damages. Benefits resulting from the reduction of information asymmetries may be particularly large in the case of representative actions. Generally speaking, consumer associations have a better knowledge of the applicable laws than individual consumers, so they are better able to assess whether certain behaviour of firms constitutes an infringement. The organisations can employ lawyers who are specialized in the relevant fields of law. This could even make the consumer organisation the better-informed party regarding the applicable rules. Obviously, there still will be an information asymmetry regarding possible infringements in so far as they are not easily detectable. Detection requires monitoring and supervision, which is costly. For individual consumers these costs are almost by definition insurmountable, but consumer organisations might acquire adequate funding for such investigations by charging their members a membership fee or by means of sponsoring.

Thanks to collective actions, economies of scale can be achieved. It is more expensive for individual consumers to investigate possible infringements in their own separate cases than for a group of consumers who jointly initiate a collective action. Consequently, it is not the inferior information of individual consumers that determines whether there is a real threat of liability, but the better information of the group of harmed consumers. The achievable economies of scale are larger under opt-out collective actions than under an opt-in scheme, since the number of harmed consumers reached will be larger. Economies of scale are even more important if the investigation is done by a consumer organisation which can monitor market participants more regularly. Furthermore, consumer organisations are repeat players, whereas individual consumers are one-shotters.<sup>28</sup> Representative actions by consumer organisations may restore the balance that is lost in interactions between one-shotters and repeat players.

### 3.2.2 Collective actions as a remedy to the rational apathy problem

Collective actions may be able to solve a number of causes of the rational apathy problem. Firstly, from the point of view of an individual claimant the cost-benefit ratio of collective actions is clearly superior to the net benefits of an individual claim. If collective actions allow compensation of the losses of an entire group of harmed consumers, the cost-benefit ratio improves further. Secondly, collective actions spread the risk of uncertainty over a large number of affected individuals, and this will increase the number of claims brought in courts. Finally, the free-riding problem can be solved if those who benefit from a successful collective action are forced to contribute to its costs. These benefits will be elaborated on below.

#### *a Reduced costs and increased benefits<sup>29</sup>*

An individual will only start legal proceedings if the expected utility of the lawsuit exceeds its costs. These costs are lower in the case of collective actions than in the case of separate individual actions, because they are spread over a large group of injured people. The expected utility will be higher in the case of the violation of subjective rights than in the event of

<sup>28</sup> M. Galanter 'Why the "Haves" Come Out Ahead: Speculations on the Limits of Legal Change', 9 *Law & Society Review* 95 (1974).

<sup>29</sup> See A. van Aaken 'Massenklagen im öffentlichen Recht aus institutionenökonomischer Sicht: Eine Art der direkten Volksrechte', 86 *Kritische Vierteljahresschrift für Gesetzgebung und Rechtswissenschaft* 44 (2003) at 55 et seq.

infringement of diffuse interests. In the latter case the court decision is a public good, since it creates non-rivalrous and non-excludable benefits.

The possibility of a collective action increases the number of lawsuits, because the expected net benefit will be higher than in the case of an individual claim. After all, the costs of the lawsuit decrease while the probability of winning the suit (and thereby the expected utility as well) increases if multiple plaintiffs have larger financial means, enabling them to have better access to evidence and get better legal advice. The problem of rational apathy is therefore reduced. Furthermore, an individual party is more likely to initiate proceedings in the case of a violation of a subjective right than in the case of diffuse harmed interests, since the net benefit of a successful claim is higher in the former scenario. In diffuse interest cases, where the expected utility is too low to start an individual claim, the possibility of collective actions could make a claim feasible. After all, the costs per person are lower with a collective action, so that the net expected benefits (the expected benefits minus the costs) might turn out positive. In some cases, however, the diffuse interests are so immaterial to the injured parties involved that even the possibility of collective actions does not lead to a lawsuit.<sup>30</sup>

Besides the high litigation costs, the rational apathy may also be due to the fact that the size of the expected damages is low. Collective actions not only decrease litigation costs in the way described above but also increase the prospective damages awards. Every collective action that is initiated in cases where no individual suits would have been brought increases the total sanction faced by a potential law infringer. The latter effect appears to be stronger under an opt-out collective action than under an opt-in scheme, since the group of compensated consumers tends to be larger. Moreover, empirical evidence indicates that actual opt-out rates are extremely low.<sup>31</sup> Therefore, the size of the sanction expected under opt-out will be larger than under opt-in (and the largest under a mandatory regime).

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<sup>30</sup> In the United States these losses are called 'nonviable claims'. The expenses an individual would incur in asserting a right to a share of a class judgment would be greater than his expected share of the recovery. In a Dutch publication regarding such losses they are termed 'scattered losses' (*strooischade*). Examples include charging too high interest rates or other surcharges by credit card companies, incorrect rounding off of gasoline prices by gasoline station proprietors in the same distribution chain and incorrect rounding off of prices by shopkeepers as a result of the intended abolishment of eurocents. See I.N. Tzankova, *Strooischade* (Deventer: Kluwer 2005) at 20, 21.

<sup>31</sup> With respect to the US, the average opt-out rate is not higher than 0.6 percent. See T. Eisenberg and G.P. Miller, 'The Role of Opt-Outs and Objectors in Class Action Litigation: Theoretical and Empirical Issues' (March 23, 2004) *NYU, Law and Economics Research Paper No. 04-004; Cornell Law School Research Paper No. 04-019*. Available at SSRN: <http://ssrn.com/abstract=528146>.

*b Risk spreading*

Under collective actions, plaintiffs no longer run the risk of having to bear extensive (litigation) costs if they lose the case. If they bundle their claims, so that only one lawsuit is initiated instead of many separate ones, they share the costs. Even if the costs of this collective claim are higher than the costs of a single individual claim, they will certainly be lower than the costs of all separate claims added together. Each individual plaintiff now only has a lower amount at stake. The financial effect of losing the case is spread over all individuals participating in the collective action, so that each individual only bears a small amount if the case is lost. People are better able to bear a small loss than a larger loss, so that the barriers to start a lawsuit are lowered. This will lead to more claims being filed.

In cases where a consumer association files a claim on behalf of its members, the costs of the lawsuit are spread over all members. They pay for these costs through their membership fee. If the case is lost and the association has to pay legal expenses, the members do not pay for these losses directly. Obviously, the more often the association files claims and loses, the higher the membership fee has to be in order to cover these costs. The membership fee in this respect resembles an insurance premium: by collecting enough fees (insurance premiums), the association (insurance company) acquires adequate funds to be able to file the claim (cover the insured event). Each individual member (insured) is certain to 'lose' the fee (premium) but no longer runs the risk of having to pay the full legal expenses of an individual claim (the insured event).

Finally, American-style class actions in which damages are claimed are also able to spread or shift risks, mainly because they are almost always accompanied by a system of contingency fees.<sup>32</sup> In essence, the attorney takes the risk of losing the case, because he only receives a fee if the case is won (no cure, no pay). The fee often consists of a percentage of the awarded damages (*quota pars litis*). If the case is lost, the plaintiffs do not pay anything and hence run no risk. If the case is won, the attorney's fee is deducted from the compensation received and the remaining damages are paid in one form or another to the plaintiffs. In this situation, they do not run a risk either. Of course, the attorney will charge a risk premium for this construction. This explains why the attorneys receive a relative large fraction

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<sup>32</sup> It would be impossible to collect small contributions for costs of council from all plaintiffs in advance, so a system of contingency fees is necessary to enable the use of class actions. See H-B. Schäfer, 'The Bundling of Similar Interests in Litigation. The Incentives for Class Actions and Legal Actions taken by Associations', 9 *European Journal of Law and Economics* 183 (2000) at 192.



of the damages as legal fee (often about 30%). The plaintiffs pay ex post for the legal services by receiving a lower amount of damages. This is the price they have to pay for shifting the risk. Given that each individual plaintiff receives a lower amount, this can still be regarded as a form of risk sharing.

### 3.2.3 Solving the free-riding problem

In collective actions initiated by individual consumers, a possible solution to the free-rider problem is to rule out the possibility of individual actions once a collective action has been initiated. Individuals will then no longer be able to first await the result of the collective action before deciding whether they want to initiate a private lawsuit.<sup>33</sup> The opt-out possibility that exists in many class actions and other forms of collective actions, as well as in the Dutch system of declaring the settlement contract binding, should then be abolished. The free-rider problem may also be tackled by increasing the costs of individual claims after a collective action has been undertaken. If the costs increase for plaintiffs who do not have a compelling argument for not joining the collective claim, the result of weighing costs and benefits will change. This might lead to more individuals choosing for the collective action. In essence, the free-ride (which Stigler correctly argues is actually a 'cheap ride' because the profiteer incurs the costs of the lower expected gain of the collective action)<sup>34</sup> becomes more expensive and hence less attractive.

In cases where the individual losses are high enough to make individual claims feasible, the free-rider problem seems limited because individual victims will start a lawsuit to collect damages anyway, irrespective of what others do. Given that the costs of litigation decrease per plaintiff if they bundle their claims, there will still be an incentive to collectivise, notwithstanding the free-rider problem.<sup>35</sup> In many cases of widespread losses, the individual losses of each victim are too small to make opting out an attractive strategy. By staying in the group or class, the victim contributes to the costs of the lawsuit, but also has a higher chance of receiving compensation. By opting out, the victim does not bear any costs, but given that his losses are only small, an individual suit is not worthwhile. Therefore, the possibility of free riding does not appear to be a major problem in cases with widespread losses where the victims claim

<sup>33</sup> See e.g. D. Rosenberg and J.P. Sullivan 'Coordinating Private Class Action and Public Agency Enforcement of Antitrust Law', 2 *Journal of Competition Law and Economics* 159 (2006) at 177.

<sup>34</sup> G.J. Stigler, 'Free Riders and Collective Action: An Appendix to Theories of Economic Regulation', 5 *The Bell Journal of Economics and Management Science* 359 (1974) at 360.

<sup>35</sup> H-B. Schäfer, above n. 32, at 186.

compensation.<sup>36</sup> Furthermore, given that many collective actions will be settled, it remains to be seen if the collective action provides free-riders with information that they could use in their own individual claim.<sup>37</sup> However, if the plaintiffs sue for an injunction or reform, the free-riding problem should be taken seriously. It could very well frustrate the possibilities of private enforcement, making public enforcement a better option.

Collective actions initiated by consumer associations could mitigate the free-rider problem, in as far as the association is able to charge its members a fee for the costs incurred. This way, the members are forced to contribute to the funds necessary to file the collective suit and they cannot behave as free riders. However, non-members can still behave as free riders because they do not contribute to, but still benefit from the efforts of the association. Why would an individual join the association if it limits their possibilities to take a free ride? The prevailing explanation is that the consumer association offers other benefits to its members, such as a newsletter, subsidized legal assistance and discount possibilities. Stigler has challenged this explanation: Why would consumers be willing to pay a price for these private goods and services if this price is so high that it can also be used to cover the expenses of production of the public good? A rival association offering the same private goods and services but without the collective actions would be able to charge lower prices and consumers would prefer to join this second association.<sup>38</sup> However, to the extent that competing associations are absent, the above line of reasoning still holds and the associations are able to reduce the free-rider problem.

#### 4 Disadvantages of collective actions

The story cannot end here. Even though collective actions may generate benefits in terms of economies of scale, risk-sharing, curing rational apathy of individual consumers and overcoming the free-riding problem, these advantages also come at a cost. Class actions in the United States have had a

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<sup>36</sup> This is also argued by G.P. Miller, 'Class Actions', in: P. Newman (ed.), *The New Palgrave Dictionary of Economics and the Law*, volume 1 (Houndmills: Palgrave Macmillan 1998) 257 at 260.

<sup>37</sup> H-B. Schäfer, above n. 32, at 192.

<sup>38</sup> G.J. Stigler, above n. 34 at 360. This argument is nicely illustrated by the Dutch case of the ANWB versus Route Mobiel. The ANWB is a Dutch organisation that provides signposts, an alarm service for stranded tourists, a repair and towing service for motorists whose vehicle has broken down, et cetera. Route Mobiel is an organisation that entered the market for repair and towing services in 2005. In its advertisements, Route Mobiel explicitly states that it provides the services cheaper than the ANWB, because it does not offer "the whole circus of thousands of office staff, emergency telephones and a magazine that you do not read anyway."

bad press, both from consumer lawyers and legal economists. There are two main causes for resulting inefficiencies: i) the principal-agent problem, which results from information asymmetries on the side of clients and inhibits their control of the quality of the attorney's performance; and ii) the risk of opportunistic behaviour, which leads to frivolous suits. These problems have often led European policy-makers to argue against the introduction of collective actions. However, an intelligent design of collective actions coping with the problems of the American-style class action and a greater reliance on representative actions might achieve the advantages described in the previous section of this paper without causing costs that outweigh their benefits.

#### **4.1 Principal-agent problems**

It is well-known from the literature on the regulation of the legal profession that clients (principals) face great difficulties in controlling the quality of the performance of the lawyers (agents). Information asymmetries exist which make it difficult or even impossible for the client to assess the quality of the lawyer's work. In individual cases, the client has an immediate interest, so he may try to monitor his lawyer's efforts to a certain extent. In collective actions, however, the plaintiffs' interests are often too small to undertake any monitoring activities. In American class actions, the attorney thus becomes the leading actor of the case and might pursue his private interests to the detriment of the harmed consumer group as a whole. The principal-agent problems could be exacerbated by the way in which the collective action is funded. Even though contingency fees may pay the costs of the suit (and thus improve access to justice), they create new problems. Firstly, under contingency fees the attorneys' efforts may not be optimal. Secondly, contingency fees could lead to early settlements that are disadvantageous for the clients. Both objections are explained below.

From the plaintiffs' point of view, the optimal effort of the attorney is determined by comparing marginal costs with marginal benefits. As long as the costs of additional efforts are lower than the increase in the expected benefits (the probability of winning the case, multiplied by the damages that will then be received), it is desirable that the lawyer invests additional efforts. However, the optimal effort for the lawyer himself is determined by comparing the costs of additional efforts with the increase in the expected fee, which is only a percentage of the expected benefits of the plaintiffs. Hence, the expected benefits for the lawyer of putting in additional efforts are smaller than the expected benefits for the plaintiff. This will lead him to spend less effort than the client would want him to do. This risk may be mitigated by the desire to build and maintain a good reputation. However, in

class actions the reputation mechanism cannot work in an optimal way. It is the lawyer who seeks the clients, not the other way around.<sup>39</sup>

An often heard objection to contingency fees is that they could lead to early settlements which are not in the interest of plaintiffs. Again the principal-agent problem lies at the basis of this inefficient outcome. It is attractive for the attorney, who receives a percentage of the damages awards as his fee, to settle the case if his private costs of pursuing the claim outweigh the expected increase in the fee to be received. For the class members it could be better if the attorney continues the litigation, because their expected damages under continued legal proceedings may be higher than the settled amount. For example,<sup>40</sup> if there is an 80% chance of winning the case and the damages amount to \$10 million, the expected damages for the plaintiffs are \$8 million. If the lawyer's fee amounts to 25% of the damages awarded, his expected fee will equal \$2 million. If the defendant offers to settle for \$6 million, the attorney will receive \$1.5 million, without having to continue the litigation and running the 20% risk of losing. It is attractive for the lawyer to accept this offer if his private costs of conducting litigation and bearing the risk of losing the trial exceed \$500,000 (the difference between the expected fee when litigating and the certain fee when settling). For the plaintiffs however, the expected result of litigation is 75% of \$8 million, hence \$6 million. In the case of settlement they will only receive \$4.5 million. It remains to be seen whether they would have been willing to accept this lower amount themselves in order to receive compensation sooner and to be rid of the uncertainty of the outcome of the case. It is even possible that the defendant proposes a settlement deal which is inferior for the injured parties when compared to the expected outcome of the trial, but superior for the plaintiffs' lawyer. Suppose the plaintiffs' attorney expects an outcome at trial of \$10 million (and the defendant has the same assessment), out of which he would receive 25% as fee. If the defendant offers to settle at \$8 million, out of which \$3 million goes to the plaintiffs' lawyer, the lawyer will gain \$500,000 by settling, while the plaintiffs will lose \$2.5 million.

## 4.2 The risk of unmeritorious suits

The American experience shows that class actions may be initiated to inflict reputational harm on companies. Class actions are likely to cause higher reputational losses than individual cases, so that class actions increase the risk of opportunistic behaviour. Firms may prefer an early settlement if this costs them less than the sum of the losses of handling the case in court. The

<sup>39</sup> H-B. Schäfer, above n. 32, at 193.

<sup>40</sup> See G.P. Miller, above n. 36, at 258, 259.

size of these losses creates scope for abuses if the class attorney can easily obtain payment of damages (parts of which are paid to him under the contingency fee arrangement). Frivolous suits may be brought if the amount of this payment for the company is lower than the costs of defending itself in court. This can even happen if the class attorney is certain that he will lose the case, because the costs for the defendant of going to court (legal fees and reputational harm, for example) might outweigh the settlement amount.

In addition, class actions increase the expected payment (and therefore under contingency fees the lawyer's payment as well) by far more than the increase in the lawyer's costs. Assuming that the lawyer will only take on a case if his expected payment is higher than his expected costs, he will be willing to take on a class action at a much lower probability of success than he would take on an individual case. It remains to be seen if such cases are desirable on a social level, given the low probability of success in the first place.<sup>41</sup>

The question arises whether the problems discussed above can be mitigated by imposing restrictive conditions on collective actions. Defendants who win the case could be given the right to claim their lawyers' expenses from their unsuccessful opponents. This will lower the attractiveness of unmeritorious claims, although the possibility of reputational harm might still induce defendants to settle. Other solutions require more drastic changes and a different institutional design of collective actions. These alternatives are discussed in the next section.

### **4.3 How to avoid principal-agent problems and frivolous suits**

Different solutions have been suggested to mitigate principal-agent problems and to overcome the risk of frivolous suits in collective actions. More restrictive conditions could be imposed on collective actions. There also may be a preference for a greater reliance on representative actions brought by consumer associations, provided that the accountability problem can be solved.

#### **4.3.1 Restrictive conditions on collective actions**

To mitigate the principal-agent problems, it has been suggested a public auction be held for selecting the attorney in charge of representing victims and compensating the claimants and the lawyer through the proceeds of the auction.<sup>42</sup> The defendant's attorney himself can also bid in the auction. If he

<sup>41</sup> H-B. Schäfer, above n. 32, at 189.

<sup>42</sup> J.R. Macey and G.P. Miller 'The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform', 58 *University of Chicago Law Review* 1 (1991); J.R. Macey and G.P. Miller

wins, in essence a settlement is reached. The underlying idea is that the auction will reveal the lawyer best qualified to litigate the case in the most efficient way. Agency problems are solved because ownership and control are united in a single party. However, if the auction is not properly run, this can lead to adverse selection problems so that cheaper but poor-quality lawyers will win the tender.<sup>43</sup> It would then follow that the quality of legal services decreases to the detriment of consumers.

Contingency fees may be prohibited and replaced by a fixed fee set by a governmental authority. Hay proposes to limit the fee in case of a settlement to the percentage the attorney would have received in a trial, thereby ensuring the class members a recovery not lower than the outcome of a continued litigation. He stresses that the problem with contingency fees is not primarily that the fee will be excessive if seen as a fraction of the settlement amount (20% or so), but that it is too large if compared to what the lawyer would have received if the case was tried (say, only 10%). This will induce the lawyer to settle for too small amounts. The greater the difference between the two percentages, the larger the problem will be. However, due to informational problems it remains doubtful if the fee can be set at such a level that the efforts of the lawyer who handles the case will be optimal.<sup>44</sup>

Another way to combat inadequate settlement is to introduce a preliminary test of the merits of the case<sup>45</sup> or to enable a judicial review of settlements that class members would not have agreed upon. Koniak and Cohen propose a mandatory summary judgment as a superior solution to a pre-certification merits review.<sup>46</sup> The latter solution has been adopted in the US Securities Litigation Reform Act. However, the scepticism of commentators has seemingly been confirmed, since the results of the reform

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'Auctioning Class Action and Derivative Suits: A Rejoinder', 87 *Northwestern University Law Review* 458 (1992).

<sup>43</sup> If information deficiencies make it difficult to assess the optimal amount of damages, the tender may be won by the lawyer who offers his services at the lowest price. Contingency fees mitigate this problem (since the lawyer's fee is linked to the achieved result) but create problems of their own (see above).

<sup>44</sup> B.L. Hay 'Asymmetric Rewards: Why Class Actions (May) Settle for Too Little', 48 *Hastings Law Journal* 479 (1997).

<sup>45</sup> R.G. Bone and D.S. Evans 'Class Certification and the Substantive Merits', 51 *Duke Law Journal* 1251 (2002); G.P. Miller, 'Review of the Merits in Class Action Certification', (May 4, 2004). *Bepress Legal Series, Working Paper* 262. <http://law.bepress.com/expresso/eps/262>.

<sup>46</sup> S.P. Koniak and G.M. Cohen 'Under Cloak of Settlement', 82 *Virginia Law Review* 1051 (1996).

were ambiguous, as unmeritorious and meritorious claims alike may have been discouraged.<sup>47</sup>

Principal-agent problems in collective actions will persist if there is no adequate monitoring. In individual cases where the plaintiff has an immediate interest in the case, he will spend some resources in monitoring the lawyer, which limits the agency problems. In class actions, not even the named plaintiff will have an incentive to monitor the lawyer, given that his interest in winning the case is low. This will be truer still for the other members of the class and especially for the victims, who do not even know that they will be a member of the class at a later stage.<sup>48</sup> As a solution, courts could review the outcome of the collective action. However, courts may lack the information to be able to properly monitor the lawyer.<sup>49</sup>

#### 4.3.2 Greater reliance on representative actions

In the case of a collective action initiated by consumer associations, the risk of unwarranted side effects may be less serious. Even though this risk does not completely disappear, it could be better contained. On the one hand, consumer associations (agents) may be presumed to act in the collective interests of the consumers (principals). On the other hand, consumer associations might pursue goals of their own which conflict with objectives of consumer welfare. In particular, the risk of abuse cannot be excluded if the consumer associations are allowed to claim damages. The seriousness of this risk depends among others on the extent to which the members can control the association, the possibilities of the association to control the lawyer acting on its behalf, and the possible influence of third parties on the association.<sup>50</sup> If the first two relations are strong and the third weak, consumer associations will be well-suited to bring collective action, because they will serve as perfect agents for their principals. However, in most cases of widespread losses the members have little control over the association, which might be influenced by political groups or groups with a moral concern. The interests of the latter groups may not align with the interests of the members, so principal-agent problems might persist.<sup>51</sup>

<sup>47</sup> See several studies reviewed by J.C. Choi, 'The Evidence on Securities Class Actions', (April 7, 2004) *UC Berkeley Public Law Research Paper No. 528145*, available at SSRN: <http://ssrn.com/abstract=528145>.

<sup>48</sup> See C. Silver, 'Class Actions – Representative Proceedings', in: B. Bouckaert and G. De Geest (eds.), *Encyclopedia of Law and Economics, Volume V. The Economics of Crime and Litigation* (Cheltenham: Edward Elgar 2000) 194 at 215 ff.

<sup>49</sup> For an example, see C. Silver, above n. 48, at 215. Also see G.P. Miller, above n. 36, at 259.

<sup>50</sup> H.-B. Schäfer, above n. 32, at 198.

<sup>51</sup> Id. at 199.

To guarantee that consumer associations are truly representative, a number of requirements regarding their credibility, reputability and commitment to acting in the collective interests of consumers must be fixed and enforced. This may be achieved by conferring standing to bring a representative action only to consumer associations approved by a governmental body or granted permission by the courts for a particular case or cases. Governmental approval may be decided upon on examination of the articles of incorporation, size of the membership and geographical scope of the activities of the consumer association. Furthermore, regulations may impose requirements regarding the possibilities of members to actually control the decisions of the association.

It is interesting to note that UK research suggests that consumer associations rarely bring suit. The reason can be that associations do not see enforcement as their core business and that they are not willing to spend resources on lawsuits, which have an uncertain outcome.<sup>52</sup> Hence, collective actions brought by public bodies may be warranted after all, even if private associations, too, can start collective actions. Clearly, if a collective action is initiated by a public agency, the borderline with public enforcement will become spurious.

## 5 Conclusions

Improving consumer rights may remain meaningless if these rights are not adequately enforced. The design of enforcement mechanisms should ensure the achievement of two major goals: deterrence and compensation. In this paper, the focus of the analysis has been put on the former goal. Starting from the insight that individual claims may be insufficient to deter infringements of consumer protection laws, it has been investigated whether collective actions may overcome this enforcement deficit. Law and Economics literature advances three major reasons why private enforcement by individual consumers is insufficient from a deterrence perspective. Firstly, consumers may not realize that rules are violated or find out infringements only after harm has occurred. Secondly, consumers might be rationally apathetic and may not bring claims if the social benefit-cost calculus differs from the expected private benefits and costs of a law suit. Finally, individual consumers may wish to free-ride on the efforts of other consumers who might initiate legal proceedings. Under these circumstances, the threat of individual claims will not sufficiently deter potential law infringers. Therefore, it is regularly argued that public enforcement is necessary to prevent violations of consumer law.

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<sup>52</sup> C. Hodges above n. 27, at 1388.



This paper has investigated the question whether private collective actions can contribute to the prevention of consumer law infringements, so that one should not always resort to public enforcement. To answer this question, we must compare the benefits and costs of collective actions. On the positive side, collective actions generate information about the violation of consumer law, mitigate the rational apathy problem and may cure the free-rider problem. On the negative side, collective actions may exacerbate principal-agent problems between lawyers and clients and create scope for frivolous suits.

The size of both the benefits and costs depends on the type of collective action and its modalities. The distinction between collective actions initiated by individual consumers and representative bodies acting in the interests of consumers in general, as well as the division between opt-in and opt-out mechanisms are crucial to assess their contribution to deterrence. As far as the improvement of information flows is concerned, representative actions have a larger potential than collective actions initiated by individual consumers. For solving the rational apathy problem, opt-out collective actions are preferable to opt-in collective actions and representative actions again have the largest potential (particularly if they are organized as an opt-out or mandatory action). The free-riding problem cannot be entirely solved in collective actions, since consumers may benefit from a decision constituting a *prima facie* case in a posterior individual claim (even though they must explicitly express their wish not to be bound under an opt-out scheme). Consumer associations may mitigate the free-riding problem through charging membership fees, but may not be able to fully eliminate the risk that benefits also flow to non-members.

This paper has discussed two major disadvantages of collective actions: principal-agent problems between lawyers or representative bodies and individual consumers, and the risk of frivolous suits. Generally speaking, the ensuing costs seem to be larger with traditional collective actions than with representative actions. Experience gained with US class actions shows that attorneys may take decisions, such as early settlements, that are not in the interest of their clients and that attorneys may also initiate unmeritorious suits. These problems cannot be overcome easily. Due to informational asymmetries, it will be difficult to regulate the magnitude of the fees or to subject the outcome of the case to judicial review. In the case of representative actions, regulations may impose conditions to guarantee that consumer associations are really representative and act in the collective interests of consumers in general. The need for regulation shows that public intervention will remain necessary even if more scope is created for private collective damages actions.

Several questions for future research remain. Since collective actions are not a perfect instrument to achieve optimal deterrence, the question arises what the ideal mix of public enforcement and private enforcement of

consumer protection law should look like. If the contribution of collective actions to deterrence remains modest, their potential to achieve corrective justice will become the focal point of the analysis. If the attention shifts from deterrence to compensation, a number of different questions will emerge.

How large will the group of consumers be who have suffered harm as a consequence of infringements of consumer law and who will be compensated thanks to the availability of a collective action? How can it be assured that the damages awards are aligned with the magnitude of the actual harm suffered? How must the damages be collected and distributed? How can victimized consumers be identified? What would be the optimal use of damages awards that cannot be distributed to individual consumers? These and other questions could not be addressed within the confines of this paper. Obviously, they must be analysed thoroughly before any policy conclusions on the desirability of collective actions may be drawn.