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***The Cy Pres Problem and the  
Role of Damages in Tort Law***

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## THE CY PRES PROBLEM AND THE ROLE OF DAMAGES IN TORT LAW

*Goutam U. Jois\**

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### Abstract

*Class action litigation presents a common problem that has received little discussion in the academic literature. In almost every case, the plaintiff class's recovery is not fully distributed. For example, all possible plaintiffs may not come forward with their claims, the plaintiffs may not be ascertainable, or claims may not be timely submitted. Administrators are regularly posed with the problem of what to do with these residual funds. Currently, courts are free to do virtually anything with such funds. The system is ad hoc, unpredictable, and unguided by any normative principle.*

*In these cases, I propose that the funds should escheat to the state. On a regular basis, the state could then distribute these funds to the citizenry. Ex ante, all citizens are equally likely to find themselves exposed to the risk that led to the class recovery in the first place. Escheat to, and distribution through, the state thus disburses money on average equally to all of those who are potential victims.*

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*I generalize from the context of residual funds to argue that recovery in all class actions and other collective adjudication should escheat to the state for distribution (assuming that losses are small relative to wealth or that pecuniary loss is covered by first-party insurance). Individuals would not be compensated ex post in close tailoring to their actual loss as under the current tort system, but with a view to the average risk borne ex ante. Ex ante, individuals could find themselves in any of several worlds (wealthy, poor, injured, not injured, &c.), and since all individuals expect to share in an increase in the state's treasury, money in state coffers would accrue to the benefit of all individuals. Distributed this way, tort damages would solve several problems: the link between harm and compensation, uncertainty, distorted consumption and production incentives, free-riding, and high administrative costs. This argument dramatically reshapes the way damage awards are viewed in our tort system.*

## I. INTRODUCTION

Class action practice regularly presents a problem that has received very little discussion in the academic literature. In many cases, the plaintiff class's recovery is not fully distributed. For example, all possible plaintiffs may not come forward with their claims, the plaintiffs may not be ascertainable, or claims may not be timely submitted. A certain amount of money may be budgeted for administration but actual administrative costs may fall short of this amount. In case after case, for a variety of reasons, administrators are posed with the problem of what to do with these "leftover" funds -- sometimes totaling in the tens of millions, or as much as a third of the overall class fund.<sup>1</sup>

Under the status quo, courts are free to do virtually anything with such funds. As a result, the system is ad hoc, unpredictable, and generally unprincipled. More to the point -- and relevant for the purposes of this paper -- scholars have put forth no arguments as to why the leftover funds should be distributed in one way as opposed to another. Even the popular press has picked up on this problem, noting the unseemly prospect of charities essentially hiring lobbyists to persuade judges that these leftover funds should come to them.<sup>2</sup> In sum, the problem of leftover class action funds is widespread, it has not been squarely addressed in the academic literature, and the status quo leaves the door wide open for abuse.

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<sup>1</sup> See *infra* notes 10 - 14 and accompanying text (discussing the general problem of residual funds).

<sup>2</sup> See *infra* note 15 and accompanying text (discussing an article in the New York Times).

In theory, these cases are guided by the cy pres doctrine, under which a court is to distribute the funds as closely as possible to the initial reason for the distribution of the money.<sup>3</sup> Unfortunately, given the wide range of groups to which the courts give money -- hospitals, law schools, libraries, or even a camp -- the practice is more akin to a legislative earmark than a principled distribution. In reality, cy pres is merely a label that can be affixed to whatever courts do with residual funds.

In this paper, I propose that these leftover funds escheat to the state. On a regular basis, the state could then distribute these funds to the citizenry. Ex ante, all citizens are equally likely to find themselves exposed to the risk that led to the class recovery in the first place, and all citizens expect to share in the benefits associated with an increase in the state's treasury. Escheat to, and distribution through, the state thus disburses money equally and on average to all citizens -- that is, to all of those who are potential victims.

I generalize from this specific case to argue that, under certain commonly-satisfied assumptions, recovery in all class actions and other collective adjudication should escheat to the state for distribution. (The two key assumptions are that losses are small relative to wealth or that pecuniary loss is covered by first-party insurance.) Under the current tort system, individuals are compensated ex post, after they sustain some injury. Additionally, the law attempts to tailor individuals' damages closely to their actual loss. In theory, the current system allows individuals with small claims to aggregate them, prosecute the suit as a class action, and then divide the recovery pro rata. Each individual then receives compensation ex post that precisely makes up for the loss he suffered ex ante.

This theoretically neat system involves a series of disadvantages. First, it inextricably links harm and compensation: in order to get paid, an individual must suffer some harm. Second, even after an individual gets harmed, compensation remains an uncertainty: his claim might have expired, or be procedurally barred, or fall victim to one of several other hurdles before he receives money.

Taken together, these two shortcomings of the current system distort society's consumption and production incentives. Risk aversion distorts these incentives even further. An individual should "rationally" be indifferent between suffering some loss today and getting compensated later on the one hand, and not being injured at all on the other. However, risk averse individuals would prefer the latter; as a result, they will not buy risky widgets (or whatever), depriving society of some benefits.<sup>4</sup> The uncertainty of compensation only serves to compound this problem.

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<sup>3</sup> See *infra* notes 37 - 38 and accompanying text (discussing the cy pres doctrine).

<sup>4</sup> See *infra* note 86 and accompanying text (discussing risk aversion).

A third shortcoming of the status quo is that individuals have incentives to free-ride. If someone else brings a class action, the deterrence and compensation benefits will eventually accrue to *me* -- and if *I* bring the suit, the chances that I will get compensated are no higher, because a lead plaintiff faces the same hurdles as anyone else.

Finally, and most prominent, the status quo involves extremely high administrative costs. Potential plaintiffs must be identified, claims processed, and class funds administered; an industry exists just to administer these class funds.<sup>5</sup> These costs easily run into the millions of dollars in complex cases, and can amount to a significant percentage of the overall class recovery.

In this paper, I propose that individuals be compensated with a view to the average risk borne ex ante, not in close tailoring to the actual loss suffered ex post. This is accomplished by delivering money from all collective adjudication -- not just cy pres cases -- directly to the state.

Ex ante, individuals could find themselves in any of several worlds (wealthy, poor, injured, not injured, &c.). Also, all individuals expect to share in an increase in the state's treasury. As a result, increased money in the state coffers would accrue to the benefit of all individuals. When distributed this way, the system solves each of the problems outlined above. First, compensation is a certainty, because the individual would be compensated by the state on a regular basis, regardless of the status of some current lawsuit. Risk aversion becomes moot, because individuals have essentially been compensated ex ante, through the state, for their loss. As a result, my proposal corrects the currently-distorted consumption and production incentives.

Ex ante distribution also eliminates the free-rider problem. Under the proposed system, money escheats to the state, so there is no need for a "lead plaintiff" in the traditional sense of the term; as argued elsewhere,<sup>6</sup> the contingency fee system will provide incentives for lawyers to find and litigate these kinds of cases, establishing the correct deterrent signal.

Finally, escheat to the state is nearly costless. As a result, my proposal involves dramatically lower administrative costs -- costs that can eat up large portions of overall class recovery under the status quo. The savings provides a net gain to society.

The academic literature provides no principle to guide the distribution of leftover class action funds. In this paper, I identify a social objective -- namely, optimal deterrence and increased welfare -- propose a solution, and

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<sup>5</sup> See, e.g., <http://www.strategicclaims.net> (website of Strategic Claims Services); <http://www.abdata.com> (website of A.B. Data Group) (both sites last visited March 11, 2008).

<sup>6</sup> See *infra* note 70 and accompanying text (discussing the role of contingency fee lawyers in bringing these suits).

evaluate how the proposal achieves the goals of the social objective. I demonstrate that escheat to the state is a superior method of distributing funds not only in cases where residual common fund money exists, but in collective litigation generally. Doing so would dramatically reconceptualize the role of damages in tort law. Instead of viewing tort damages as an ex post entitlement linked to a specific harm, my theory conceives of damages as an ex ante tool to compensate individuals on average for the entire menu of risks they face.

The balance of this paper elaborates on the solution I propose to the cy pres problem and then the more expansive application of this argument. Part II describes the cy pres problem in some detail, demonstrating the problems with the status quo. Currently, courts are free to do almost anything with undistributed class funds.<sup>7</sup> This leads to a system that is ad hoc, unpredictable, unguided by any normative principle, and open to the possibility of abuse. Additionally, though citizens were equally exposed to the given risk ex ante, they do not equally benefit from the compensation. Giving money to a law school, a public interest organization, charity, or medical center might be worthwhile. However, the people initially exposed to the risk do not benefit from such distributions. Therefore, I propose that these residual funds escheat to the state. The proposal increases social welfare by correcting distorted incentives, lowering administrative cost, and reducing the possibility of abuse.

Part III takes a step back from the cy pres doctrine to canvass arguments regarding the role of tort damages generally. This section provides a transition between the paper's doctrinal focus and its broader theoretical implications.

Part IV explicates the "special normative theory for ex ante compensation," which I propose in lieu of ex post compensation tailored closely to individuals' actual losses, as is done through the status quo tort system (through class actions or otherwise). The benefits described above apply with greater force in this expanded application. I give examples from tort law and corporate law to demonstrate how such a system would work.

Part V examines some counterarguments. For example, all risks may not be accurately calculated, so that the damage award over- or under-compensates the actual societal loss. The phenomenon of adaptive preferences suggests that market-revealed choices may not increase utility, and deontologists might argue against the utilitarian assumptions underlying the paper. Finally, there may be some procedural difficulties in implementing my proposal. To the extent that these criticisms have merit, I do not see them as detracting from the viability of the normative theory,

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<sup>7</sup> See Kevin M. Forde, *What Can a Court Do with Leftover Class Action Funds? Almost Anything!*, 35 JUDGES' J. 19 (1996).

because they apply with equal strength to other tort compensation regimes. Insofar as my system improves upon the status quo, it must be superior.

## II. THE CY PRES PROBLEM

“In virtually every class action, there remains a reserve fund after all claims and expenses have been paid.”<sup>8</sup> The first question I address in this paper is what to do with this residuum.

This problem can arise for one of several reasons. First, fund administrators may simply not be able to identify all members of the plaintiff class. Second, people who would otherwise be eligible to share in the recovery might not submit claims at all or might not submit claims in the appropriate manner. Finally, the costs of identifying and notifying the class members may be higher than the amount of their potential recovery, such that notifying the members would deplete the entire fund.<sup>9</sup>

The money left over could be quite substantial. For example, in *West Virginia v. Chas. Pfizer & Co.*,<sup>10</sup> almost a third of the fund was undistributed -- \$32 million left following a settlement of \$100 million. *Van Gemert v. Boeing*<sup>11</sup> involved over \$2.5 million left unclaimed, *In re Folding Carton Antitrust Litigation*<sup>12</sup> had \$8 million unclaimed following a \$200 million settlement, and *Vasquez v. Avco Financial Services*<sup>13</sup> involved a surplus of \$1 million after an action in California state court. An antitrust case in New York involving fashion models ended with over \$6 million unclaimed.<sup>14</sup> The problem I address is not rare and often involves significant amounts of money.

Thus, under the status quo, there are significant amounts of money left undistributed when mass tort litigation is completed. Where should this money go? Ex post, the answer is clear: it should come to me! Individuals and organizations essentially lobby courts to receive the leftover funds, and

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<sup>8</sup> *In re Folding Carton Antitrust Litig.*, 557 F. Supp. 1091, 1104 (N.D. Ill. 1983), *aff'd* 744 F.2d 1252 (7th Cir. 1984), *cert. dismissed*, 471 U.S. 1113 (1985).

<sup>9</sup> See, e.g., Forde, *supra* note 7, at 19; Natalie A. DeJarlai, Note, *The Consumer Trust Fund: A Cy Pres Solution to Undistributed Funds in Consumer Class Actions*, 30 HAST. L. J. 729, 729 (1987);

<sup>10</sup> 314 F. Supp. 710 (S.D.N.Y. 1970), *aff'd*, 440 F.2d 1079 (2d Cir.), *cert. denied*, 404 U.S. 871 (1971).

<sup>11</sup> 739 F. 2d 730 (2d Cir. 1984).

<sup>12</sup> *In re Folding Carton Antitrust Litig.*, 557 F. Supp. 1091, 1104 (N.D. Ill. 1983), *aff'd* 744 F.2d 1252 (7th Cir. 1984), *cert. dismissed*, 471 U.S. 1113 (1985).

<sup>13</sup> No. NCC 11933 B (Los Angeles Super. Ct., Apr. 24, 1984) (order approving *cy pres* remedy).

<sup>14</sup> See *Fears v. Wilhelmina Model Agency, Inc.*, 2005 U.S. Dist. LEXIS 7961 (S.D.N.Y. May 5, 2005).

at least some are successful.<sup>15</sup> As Adam Liptak has noted in the *New York Times*, judges are put in the business of “doling out other people’s money,” a process that looks unseemly at best, and opens up the possibility of corruption at worst.

Liptak argues persuasively that the ambiguity associated with left over funds leaves the court too much power in deciding where that money should go, transforming judges into grant supervisors.<sup>16</sup> Under the current system, groups now solicit judges for consideration in instances where the court must decide what to do with left over funds. In fact, legal service organizations representing poor individuals now often rely on class action settlements to fund their services. As Samuel Issacharoff points out the question should not be whether the left over money is going to a good cause (the stated justification decisions involving leftover fund allocation), but if the court has the authority to decide where the money goes at all. Currently, the court retains this authority, and often judges give money to charities of their liking or schools they are affiliated with. Thus allocation of funds often lacks any connection to the plaintiffs.<sup>17</sup>

For example, a class action in Tennessee resulted in a \$2.9 million residuum. Vanderbilt’s law school submitted an affidavit to the court, advocating that the money come to a civil litigation and dispute resolution program at the school. Perhaps not coincidentally, plaintiffs’ counsel recommended the law school, and lead counsel for plaintiffs were both Vanderbilt graduates.<sup>18</sup> Vanderbilt did not (ostensibly) ask for this money out of self-interest: the school argued that its would train better lawyers, who would then go on to practice law in various jurisdictions around the country, including some of those in which injured plaintiffs resided.<sup>19</sup>

In an antitrust case, Judge Harold Baer of the Southern District of New York had the parties recommend various charities to distribute an approximately \$6 million residuum.<sup>20</sup> After soliciting suggestions from the

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<sup>15</sup> See, e.g., Adam Liptak, *Doling Out Other People’s Money*, N.Y. TIMES, Nov. 26, 2007 (discussing the distribution in *Fears v. Wilhelmina Model Agency*, which I discuss below); *New Civil Litigation and Dispute Resolution Program Grated \$2.9 Million*, VANDERBILT NEWS SERVICE, at [http://www.vanderbilt.edu/news/releases/2005/10/31/new\\_civil\\_litigation\\_and\\_dispute\\_resolution\\_program\\_grated\\_2.9\\_million\\_court\\_determined\\_vanderbilt\\_would\\_be\\_fitting\\_beneficiary\\_of\\_class\\_action\\_lawsuit](http://www.vanderbilt.edu/news/releases/2005/10/31/new_civil_litigation_and_dispute_resolution_program_grated_2.9_million_court_determined_vanderbilt_would_be_fitting_beneficiary_of_class_action_lawsuit) (last visited April 22, 2007).

<sup>16</sup> See, e.g., Adam Liptak, *Doling Out Other People’s Money*, N.Y. TIMES, Nov. 26, 2007.

<sup>17</sup> See, e.g., Adam Liptak, *Doling Out Other People’s Money*, N.Y. TIMES, Nov. 26, 2007.

<sup>18</sup> See Vanderbilt, *supra* note 15.

<sup>19</sup> See *id.*

<sup>20</sup> See *Fears v. Wilhelmina Model Agency, Inc.*, 2005 U.S. Dist. LEXIS 7961, at \*39-51 (S.D.N.Y. May 5, 2005). The Second Circuit remanded, instructing the district judge to consider the possibility of treble damages for the individuals who actually did present valid claims. See *Masters v. Wilhelmina Model Agency, Inc.*, 473 F.3d 423, 433-36 (2d Cir. 2007). However, the Second Circuit explicitly stopped short of holding that the cy pres distribution

parties, Judge Baer divided the money between seven charitable organizations, with awards ranging from \$250,000 to \$1 million.<sup>21</sup> The groups ranged from “a national education campaign for women about heart disease,”<sup>22</sup> to civil legal services,<sup>23</sup> to a medical center that would focus on women’s cardiovascular health.<sup>24</sup> Judge Baer even transformed the court into something of a grant administrator, requiring annual reports, monitoring the charities’ progress, and establishing a process for continued funding. The order outlining the distribution specified:

After the initial distribution, additional distributions will be contingent upon achievement. Each entity will provide the Court in an annual report, with information detailing what the project has accomplished and the Court will retain jurisdiction over this aspect of the lawsuit. The available funds (after all claimant dollars, attorneys’ fees, and expenses have been disbursed) will be deposited by the Administrator with the Clerk of Court and placed in the Court Registry Investment System, Interest Bearing Account. Second year funds, where there is a second year, will only be released on authorization from the Court and based on the progress reported in the annual report for the first year. The annual report will be forwarded to the Court eleven (11) months after the date of the initial distribution. Where the disbursement is in two installments, the second installment will include any accumulated interest. Any funds not allotted to any entity for failure to achieve reasonable progress or expansion, or for any other reason, shall be awarded to one of the remaining projects.<sup>25</sup>

Even if one leaves aside the question of whether the distributions themselves are justifiable, there is, as Issacharoff points out, an entirely separate issue of whether reviewing annual reports and monitoring “reasonable progress” of various charities’ activities is the best use of a court’s time.<sup>26</sup> This controversial authority results from ex post payment

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in general, or the method in particular, was an abuse of discretion. *See id.* at 435 (“We are not yet prepared to say that the District Court abused its discretion in allocating the Excess Funds under the Cy Pres Doctrine.”).

<sup>21</sup> *Fears*, 2005 U.S. Dist. LEXIS 7961, at \*39-52.

<sup>22</sup> *Id.* at \*50.

<sup>23</sup> *Id.* at \*49.

<sup>24</sup> *Id.* at \*46-\*49.

<sup>25</sup> *Id.* at \*37-38.

<sup>26</sup> It is also worth noting that all of the money was distributed within New York City and largely targeted women, even though the court acknowledged that about 40% of class

problems associated with the difficulty in identifying class members and subsequent inadequacies relating to full distribution of funds, consistently leaving the court with the power to decide where left over funds should go. However, these complications would be avoided under a structure of escheat to the state.

At least two states have embraced the idea of “courts as grant administrators.” Washington State requires at least twenty-five percent of residual funds to be given “disbursed to the Legal Foundation of Washington to support activities and programs that promote access to the civil justice system for low income residents of Washington State.”<sup>27</sup> In Illinois, the judge must distribute residual funds following judgment to one or more nonprofit organizations that meets certain criteria.<sup>28</sup> Following a settlement, the judge must do the same, except that the judge has nearly unlimited discretion as to half of the fund; “up to 50% of the residual funds may be distributed to one or more other nonprofit charitable organizations or other organizations that serve the public good if the court finds there is good cause to approve such a distribution.”<sup>29</sup>

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members were men and about 60% were not from the New York, New Jersey, or Connecticut area. *See id.* at \*35 n.14.

<sup>27</sup> State of Washington Rule CR 23(f). The Rule reads in its entirety:

(f) Disposition of Residual Funds.

(1) "Residual Funds" are funds that remain after the payment of all approved class member claims, expenses, litigation costs, attorneys' fees, and other court-approved disbursements to implement the relief granted. Nothing in this rule is intended to limit the parties to a class action from suggesting, or the trial court from approving, a settlement that does not create residual funds.

(2) Any order entering a judgment or approving a proposed compromise of a class action certified under this rule that establishes a process for identifying and compensating members of the class shall provide for the disbursement of residual funds. In matters where the claims process has been exhausted and residual funds remain, not less than twenty-five percent (25%) of the residual funds shall be disbursed to the Legal Foundation of Washington to support activities and programs that promote access to the civil justice system for low income residents of Washington State. The court may disburse the balance of any residual funds beyond the minimum percentage to the Legal Foundation of Washington or to any other entity for purposes that have a direct or indirect relationship to the objectives of the underlying litigation or otherwise promote the substantive or procedural interests of members of the certified class.

*Id.*

<sup>28</sup> 735 ILCS 5/2-807(c).

<sup>29</sup> *Id.* 5/2-807(b). The Rule reads in its entirety:

Sec. 2-807. Residual funds in a common fund created in a class action.

(a) Definitions. As used in this Section:

“Eligible organization” means a not-for-profit organization that:

(i) has been in existence for no less than 3 years;

The “courts as grant administrators” scenario also raises issues concerning what Hanson and Yosifon term “deep capture.”<sup>30</sup> At least since the time of George Stigler, scholars have worried about the problem of regulatory capture: the idea that regulatory agencies will get “captured” by the entities they are meant to monitor, so that regulation favors those interest groups, not the public at large.<sup>31</sup> Hanson and Yosifon argue that there are incentives to capture a range of public institutions, from the media to universities to think tanks, not just regulatory agencies. When courts are put in the business of “doling out other people’s money,” as Liptak writes,<sup>32</sup> the possibility is heightened for deep capture of the courts themselves.

Admittedly, these charities may be doing worthwhile work. However, it is not clear how individuals who suffered from illegal price-fixing

(ii) has been tax exempt for no less than 3 years from the payment of federal taxes under Section 501(c)(3) of the Internal Revenue Code;

(iii) is in compliance with registration and filing requirements applicable pursuant to the Charitable Trust Act and the Solicitation for Charity Act; and

(iv) has a principal purpose of promoting or providing services that would be eligible for funding under the Illinois Equal Justice Act.

“Residual funds” means all unclaimed funds, including uncashed checks or other unclaimed payments, that remain in a common fund created in a class action after court-approved payments are made for the following:

(i) class member claims;

(ii) attorney's fees and costs; and

(iii) any reversions to a defendant agreed upon by the parties.

(b) Settlement. An order approving a proposed settlement of a class action that results in the creation of a common fund for the benefit of the class shall, consistent with the other Sections of this Part, establish a process for the administration of the settlement and shall provide for the distribution of any residual funds to one or more eligible organizations, except that up to 50% of the residual funds may be distributed to one or more other nonprofit charitable organizations or other organizations that serve the public good if the court finds there is good cause to approve such a distribution as part of a settlement.

(c) Judgment. A judgment in favor of the plaintiff in a class action that results in the creation of a common fund for the benefit of the class shall provide for the distribution of any residual funds to one or more eligible organizations.

(d) State and its political subdivisions. This Section does not apply to any class action lawsuit against the State of Illinois or any of its political subdivisions.

(e) Application. This Section applies to all actions commenced on or after the effective date of this amendatory Act of the 95th General Assembly and to all actions pending on the effective date of this amendatory Act of the 95th General Assembly for which no court order has been entered preliminarily approving a proposed settlement for a class of plaintiffs.

The implementing bill provides that the effective date is July 1, 2008.

<sup>30</sup> See Jon D. Hanson & David Yosifon, *The Situation: An Introduction to the Situational Character, Critical Realism, Power Economics, and Deep Capture*, 152 U. PA. L. REV. 129, 202-285 (2003) (describing the deep capture hypothesis and giving examples of deep capture).

<sup>31</sup> See George Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON & MGMT. SCI 3 (1971).

<sup>32</sup> See Liptak, *supra* note 15.

practices involving Dow Chemical would be benefited by the funding of a program on civil litigation and dispute resolution at Vanderbilt.<sup>33</sup> It is even less clear how citizens generally benefit. From an ex ante perspective, one has no expectation (or at least a very low expectation) of going to law school, participating in a civil litigation program, or studying dispute resolution. However, the individual does expect to have a pro rata share in government money. Thus, given the choice ex ante between money for a law school program or money to the state, the individual would choose the latter, because those benefits accrue to him with certainty while the latter do not.

The same point applies to other methods of distributing leftover class action funds. Some courts have required a future price reduction on the items in question until the total amount of the discount (profits forgone by the tortfeasor) is equal to the amount of the excess.<sup>34</sup> Others have suggested distributing coupons to class members, something that could result in unclaimed coupons, the equivalent of undistributed funds.<sup>35</sup>

Under the status quo, when money is left over, courts have wide equitable discretion to distribute the funds as they see fit.<sup>36</sup> The cy pres doctrine directs courts to “put[] the unclaimed fund to its next best compensation use, e.g., for the aggregate, indirect, prospective benefit of the class.”<sup>37</sup> Cy pres means “as near as possible;” “[c]ourts have utilized cy pres distributions where class members are difficult to identify, or where they change constantly, or where there are unclaimed funds.”<sup>38</sup> This doctrine is rooted in the inherent equitable powers of the district court.

As a result, the distribution occurs without any overriding normative principle. Courts have directed money to a law school’s program on civil

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<sup>33</sup> See Vanderbilt, *supra* note 15.

<sup>34</sup> See, e.g., *Daar v. Yellow Cab Co.*, 433 P.2d 732 (Cal. 1967) (taxicab rate reductions); *Colson v. Hilton*, 59 F.R.D. 324 (N.D. Ill. 1972) (telephone charge rates), *cited in* Forde, *supra* note 7, at 19 n. 4.

<sup>35</sup> See, e.g., A. Mitchell Polinsky & Daniel L. Rubinfeld, *A Damage-Revelation Rationale for Coupon Remedies*, at <http://ssrn.com/abstract=688127> (last visited April 23, 2007). Note, however, that optimal deterrence is not reached when there are unclaimed coupons (because the tortfeasor only bears a cost if a coupon is cashed in) but that optimal deterrence could be reached when there is undistributed money (because the tortfeasor has already internalized the costs of his tortuous conduct).

<sup>36</sup> See, e.g., *Van Germet v. Boeing Co.*, 739 F.2d 730, 737 (1984) (rejecting an argument that undistributed money should be placed in the United States Treasury and noting that “[t]he critical determining factor . . . is that trial courts are given broad discretionary power in shaping equitable decrees,” including “equitable decrees involving the distribution of any unclaimed class action fund”).

<sup>37</sup> 2 HERBERT B. NEWBERG & ALBA CONTE, *NEWBERG ON CLASS ACTIONS* § 10:17 (4th ed. 2002)

<sup>38</sup> *Id.* at § 10:16 n. 1

litigation in a price-fixing case,<sup>39</sup> a private charitable foundation,<sup>40</sup> local law schools' libraries,<sup>41</sup> a medical center,<sup>42</sup> public interest fellowships for recent law school graduates,<sup>43</sup> and a nonprofit boys' ranch,<sup>44</sup> among other uses.<sup>45</sup> Although any of these uses serves the deterrence function,<sup>46</sup> none of the uses is optimal from an ex ante social welfare perspective.

However, even the deterrence function under the current system has flaws that can result from the possibility of misuse of left over funds. According to information from current class action administrative service companies, the benefit of redistributing leftover funds to class members after the initial distribution is complete must be weighed against the costs of that redistribution.<sup>47</sup> When it is no longer cost effective to redistribute money, the court has the power to somewhat arbitrarily decide where the left over money should be allocated. The Marketing Manager at one class action company explained that in relation to left over funds, "My understanding is that it could be returned to the defendant, retained by the government, distributed among eligible class members who filed a claim or be subject to cy pres distribution (I think charity is not uncommon)."<sup>48</sup> First, this statement underscores the wide discretion and uncertainty that attends residual funds. It also underscores the possibility that left over funds in ex post distribution cases can go back to the defendant, mitigating even the theoretical deterrence benefits of ex post compensation.

On the other hand, escheat is superior for several reasons. First, from an ex ante perspective, escheat best delivers benefits to the absent class members. Class actions of all sorts result in residual funds. Behind the veil of ignorance, a citizen does not know which of those plaintiff classes he will be a part of. Similarly, he has no expectation behind the veil to share in the benefits that accrued to a medical center or a nonprofit boys' ranch. As a result, any attempt to "target" a given plaintiff class may miss the mark. However, he does expect to benefit from additional money in the state's treasury.

Second, escheat serves deterrence goals, while the status quo does not always do so. Some cases have permitted residual funds to revert to the

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<sup>39</sup> See *supra* note 15 and accompanying text.

<sup>40</sup> *Boothe v. Recrion*, No. 74 C 1547 (N.D. Ill. 1974).

<sup>41</sup> *Girsch v. Jenson*, No. 73-652 (E.D. Pa. July 31, 1981).

<sup>42</sup> *Sanchez v. Lowell Leberman, Inc.*, No. A-77-CA-198 (W.D. Tex. 1979).

<sup>43</sup> *In re Ocean Shipgoing Antitrust Litigation*, MDL 395 (S.D. N.Y. July 29, 1991).

<sup>44</sup> *Evans v. McMorris Downtown Ford, Inc.*, No. 272, 850 (Travis Co., Texas 126th Judicial Dist. Apr. 24, 1980).

<sup>45</sup> The examples cited here, and many others, are collected in Forde, *supra* note 7, at 22 - 23.

<sup>46</sup> See *id.* at 23 ("the deterrence goals of the law are met, as the unclaimed funds do not revert to the defendant").

<sup>47</sup> Victoria Waciura, Vice President Business Development, A.B. Data (phone conversation)

<sup>48</sup> Andy Meyer, Marketing Manager, Rust Consulting, Inc. (email)

defendant.<sup>49</sup> This undermines deterrence, because the defendant is not made to internalize the full cost of its actions.<sup>50</sup>

Third, escheat best approximates the full range of benefits of the broader theory that I outline later.<sup>51</sup> In the second half of this paper, I argue that the entire fund should revert to the state and that doing so would yield a series of benefits. Escheat of the residuum approximates those benefits.

Additionally, escheat to the state would probably also be desirable from the ex post perspective of the unidentified members of the injured class. Those individuals almost certainly would not benefit from more books in the law library or a better dispute resolution clinic. Requiring money to revert to the state might be the best way to target the plaintiff class ex post in many of these cases. In any event, it should be noted that even if it was not the best way to target the class ex post, it is the only way to do so ex ante. Doing so provides a more rational and theoretically sound way of distributing funds.

Unfortunately, some courts have rejected this view. In the *Van Gemert* case, the Second Circuit upheld reversion of unclaimed money to the defendant, relying on the broad equitable discretion of the trial court to fashion remedies in cases such as these.<sup>52</sup> It is that broad equitable discretion that allows courts to do “almost anything” with undistributed class action funds -- and it is this broad equitable discretion that can have negative consequences for deterrence and social welfare.<sup>53</sup>

Note, however, that the discretion generally only applies to *undistributed* funds. In *Eisen v. Carlisle & Jacqueline*,<sup>54</sup> plaintiff brought a class action on behalf of himself and all those who had purchased “odd lots on the New York Stock Exchange between May 1, 1962 and June 20, 1966.”<sup>55</sup> Because of the size of the class and potential problems with

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<sup>49</sup> See, e.g., *Van Gemert v. Boeing Co.*, 739 F.2d 730 (2d Cir. 1984).

<sup>50</sup> Sometimes the parties are allowed to agree that residual funds will revert to the defendant. This also poses a problem for deterrence. Therefore, the escheat rule may need to be implemented as a non-waivable default. For example, one case has noted the due process interest that a defendant has in the class fund. See *Kan. Ass'n of Private Investigators v. Mulvihill*, 159 S.W.3d 857, 860 (Mo. App. 2005). This means that a defendant must have notice and an opportunity to be heard before a court disposes of the funds. See *id.*

<sup>51</sup> See *infra* Part III (describing the special normative theory).

<sup>52</sup> 739 F.2d at 737 (1984). See also, e.g., *In re M-Lee Acquisition Fund II*, 1999 U.S. Dist. LEXIS 4084 (D. Del. 1999), at \*6-8 This, of course, entirely undermines deterrence goals, because the defendants are not being made to fully internalize the costs of their harms to society.

<sup>53</sup> This discretion does have limits. In *Mulvihill*, an appeals court reversed the trial judge's decision to donate a residuum of over a million dollars to charity, because he did not consult with the parties and did not properly consider all possibilities of how to distribute the money. 159 S.W.3d 857 (Mo. App. 2005).

<sup>54</sup> 479 F.2d 1005 (2d Cir. 1973), *vacated on other grounds* 417 U.S. 156, 172-76 (1974).

<sup>55</sup> *Id.* at 1008.

identifying and notifying class members, the district court fashioned a “fluid recovery” scheme. Because each individual’s loss -- the amount he was overcharged -- was very small (just a few dollars) and the potential class was very large (several million), the district court certified the class assuming a system in which the case would go to trial on the merits, plaintiffs would be notified, and some claims paid. The remaining funds were “to be used for the benefit of all odd-lot traders by reducing the odd-lot differential in an amount determined reasonable by the court until such time as the fund is depleted.”<sup>56</sup>

The Second Circuit rejected this “fluid recovery” scheme.<sup>57</sup> The court acknowledged that the extensive administrative costs of identifying and notifying class members -- by newspaper, radio, television, etc. -- might “disappear” once a fluid recovery scheme is adopted.<sup>58</sup> Nonetheless, the court ruled that fluid recovery violated both the dictates of Rule 23 as well as “the requirement of due process of law.”<sup>59</sup> The court rejected the idea that the “class as a whole” could be “substituted for the individual members of the class.”<sup>60</sup> In other words, the court rejected the possibility of fluid recovery because it reasoned implicitly that each harmed individual ought to be compensated, *ex post*, in a way that was closely tailored to his specific harm. That is precisely the idea that I argue against here.

Along similar lines, some courts reject the idea of unclaimed money escheating to the state because they are trying to achieve some congruity between the plaintiff class and the people who actually get the money. The *Van Gremet* court, for example, noted that the *cy pres* rule would achieve the same result as escheat, “but in a more direct fashion.”<sup>61</sup> The implication seems to be that escheat would only vaguely approximate the plaintiff class and *cy pres* would more closely approximate the plaintiff class.

These courts are right in a limited sense. But if the goal for the system is long run, average compensation to accrue to all citizens, that is exactly the result that my proposal achieves. Escheat certainly would not deliver benefits directly to the odd lot traders in *Eisen* or to those who invested in Boeing in *Van Gremet*. But *ex ante*, the probability that a given individual will find himself as odd lot trader, a Boeing investor, or in one of almost-infinite other worlds corresponds to the actual probabilities of those situations in the real world. Escheat benefits all of those groups. When fully implemented, the theory provides exactly what the courts that reject

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<sup>56</sup> *Id.* at 1011 (citation and internal quotation marks omitted).

<sup>57</sup> *Id.* at 1015-18.

<sup>58</sup> *Id.* at 1017.

<sup>59</sup> *Id.* at 1018.

<sup>60</sup> *Id.*

<sup>61</sup> 739 F.2d at 736.

escheat sought. In rejecting escheat, fluid recovery, or similar theories, they simply got it wrong.

### III. THE SPECIAL NORMATIVE THEORY

#### A. ONE STEP BACK: THE ROLE OF DAMAGES IN TORT LAW

Earlier, I said that my argument significantly reconceptualizes the role of damages in tort law. This may seem like an odd statement; the role of tort damages seems fairly clear: “The point of tort damages is to compensate, to restore the status quo ante, to make the plaintiff whole.”<sup>62</sup>

Over the centuries, scholars have attempted to add some substance to this simple but simplistic account of tort law. They have put forth myriad arguments, both descriptive and normative, for tort damages.<sup>63</sup> On the deontological<sup>64</sup> side of the ledger, these include a tort victim’s entitlement to compensation,<sup>65</sup> a tortfeasor’s entitlement to pay money damages as his price to reestablish himself in society,<sup>66</sup> or a tort victim’s right to compensation based on theories of restorative<sup>67</sup> or corrective justice.<sup>68</sup> Those adopting a consequentialist perspective argue that tort damages

<sup>62</sup> John C. P. Goldberg, *Two Conceptions of Tort Damages: Fair v. Full Compensation*, 55 DEPAUL L. REV. 435, 435 (2006).

<sup>63</sup> See, e.g., Goldberg, *supra* note 62; compare Kenneth W. Simons, *Deontology, Tort, and Crime*, 76 B. U. L. REV. 273 (1996) (arguing that tort law is best understood in deontological, not consequentialist, terms) with Benjamin C. Zipursky, *Coming Down to Earth: Why Rights-Based Theories of Tort Can and Must Address Cost-Based Proposals for Reform*, 55 DEPAUL L. REV. 469, 472 (“I believe the deontologist position in tort, at least as so stated, is indefensible”).

<sup>64</sup> The deontological approach has much in common with what Weinrib calls the formalist approach; the opposite is the consequentialist or functionalist approach. “[F]unctionalist[s] might construe the plaintiff’s right of action as a mechanism for bribing someone to vindicate the collective interest in deterring the defendant’s inefficient behavior, . . . [formalists] interpret[ ] that right of action . . . [as] the assertion of a right by the plaintiff in response to a wrong suffered at the hands of the defendant.” WEINRIB, *infra* note 68, at 11 (quoted in Benjamin C. Zipursky, *supra* note 63, at 470 n. 7).

<sup>65</sup> See, e.g., Sheldon Nahmod, *Constitutional Damages and Corrective Justice: A Different View*, 76 VA. L. REV. 937, 1009-22 (1990).

<sup>66</sup> This is a torts version of the usual application of Kant’s theory to criminal law. See, e.g., Arthur Ripstein, *In Extremis*, 2 OH. ST. J. CRIM. L. 415, 417 (2005).

<sup>67</sup> See, e.g., Heather Strang & Lawrence W. Sherman, *Repairing the Harm: Victims and Restorative Justice*, 2003 UTAH L. REV. 15 (2003); but see Darren Bush, *Law and Economics of Restorative Justice: Why Restorative Justice Cannot and Should Not Be Solely About Restoration*, 2003 UTAH L. REV. 439 (2003) (arguing for a system that combines restorative and deterrence-based systems).

<sup>68</sup> See, e.g., JULES L. COLEMAN, *RISKS AND WRONGS* (1992); ARTHUR RIPSTEIN, *EQUALITY, RESPONSIBILITY, AND THE LAW* (1999); ERNEST J. WEINRIB, *THE IDEA OF PRIVATE LAW* (1995); Stephen R. Perry, *The Moral Foundations of Tort Law*, 77 IOWA L. REV. 449 (1992).

further redistributive goals<sup>69</sup> or that they function as a reward for plaintiffs (and, through the contingency fee system, a reward for entrepreneurial lawyers) and are therefore an incentive to bring suit and yield optimal deterrence.<sup>70</sup> The law-and-economics school, relatively dominant over the past generation of legal scholarship, has long held that tort damages should help insure against losses that can be cost-justifiably prevented and help deter potential tortfeasors from engaging in activities that would lead to non-cost-justifiably-preventable losses.<sup>71</sup>

In recent years, the role of punitive damages has spawned its own cottage industry in the academic literature, with scholars discussing the issue from consequentialist as well as nonconsequentialist<sup>72</sup> perspectives and in the context of certain substantive areas of law.<sup>73</sup> Recent Supreme Court cases on the subject of punitive damages<sup>74</sup> have led to their own corpus of literature reacting to the decisions.<sup>75</sup>

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<sup>69</sup> See, e.g., Kyle Logue & Ronen Avraham, *Redistributing Optimally: Of Tax Rules, Legal Rules, and Insurance*, 56 TAX L. REV. 157 (2003).

<sup>70</sup> See, e.g., Myriam Gilles & Gary B. Friedman, *Exploding the Class Action Agency Costs Myth: The Social Utility of Entrepreneurial Lawyers*, 155 U. PA. L. REV. 103 (2006); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991).

<sup>71</sup> See, e.g., RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* (7th ed. 2007).

<sup>72</sup> See, e.g., A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869 (1998) (consequentialist arguments); Edward L. Rubin, *The Incidence, Scope, and Purpose of Punitive Damages: Reconceptualizing the Runcible Remedies of Common Law*, 1998 WIS. L. REV. 131 (1998) (deontological arguments). Some articles employ some of both perspectives. See, e.g., Paul J. Zwier, *The Utility of a Nonconsequentialist Rationale for Civil-Jury-Awarded Punitive Damages*, 54 U. KAN. L. REV. 403 (2006); Nathan Seth Chapman, Note, *Punishment by the People: Rethinking the Jury's Political Role in Assigning Punitive Damages*, 56 DUKE L.J. 1119 (2007) (arguing from a consequentialist perspective that courts' striking down punitive damages usurps the jury role while suggesting that juries' actions may enunciate certain moral judgments).

<sup>73</sup> See, e.g., Thomas M. DiBiagio, *Fostering Uniform Substantive Law and Recovery -- the Demise of Punitive Damages in Admiralty and Maritime Personal Injury and Death Claims*, 25 U. BALT. L. REV. 1 (1995) (discussing punitive damages in maritime law in the context of recent cases); Alex Sienkiewicz, *Toward a Legal Land Ethic: Punitive Damages, Natural Value, and the Ecological Commons*, 15 PENN ST. ENVTL. L. REV. 91 (2006) (arguing for punitive damages to "protect those natural values that tend to suffer for human economic gain"); Michael Rustad & Thomas Koenig, *Reconceptualizing Punitive Damages in Medical Malpractice: Targeting Amoral Corporations, Not "Moral Monsters"*, 47 RUTGERS L. REV. 975 (1995).

<sup>74</sup> *BMW of North Am., Inc. v. Gore*, 517 U.S. 559 (1996); *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408 (2003); *Philip Morris USA v. Williams*, 127 S. Ct. 1057 (2007). Another punitive damages case is, as of this writing, pending. See *Exxon Shipping Co. v. Baker*, No. 07-219, 128 S.Ct. 492 (2007) (order granting certiorari).

<sup>75</sup> See, e.g., A. Benjamin Spencer, *Due Process and Punitive Damages: The Error of Federal Excessiveness Jurisprudence*, 79 S. CAL. L. REV. 1085 (2006); Jenny Miao Jiang, Comment,

My theory employs a different approach. First, it is explicitly non-deontological.<sup>76</sup> That is, I evaluate the idea of damages from an instrumental perspective, assuming a utilitarian framework in which increased individual wealth leads to an increase in social welfare.<sup>77</sup> This approach has much in common with the “law and economics” approach, which, based on a variety of assumptions,<sup>78</sup> concludes that deterrence and insurance are the primary functions of tort law and tort damages. More to the point, I begin with the understanding that, all else equal, if a different

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*Whimsical Punishment: The Vice of Federal Intervention, Constitutionalization, and Substantive Due Process in Punitive Damages Law*, 94 CAL. L. REV. 793 (2006).

<sup>76</sup> This is not to say that the argument does not (or could not) carry deontological weight. In Part 32, I explore the compatibility of my argument with a deontological position.

<sup>77</sup> However, as Richard Posner points out, “most people don’t believe—and there is no way to prove them wrong—that maximizing happiness [i.e., welfare] . . . is or should be one’s object in life.” POSNER, *supra* note 71, at 12. As I have posed the question elsewhere, “if people aren’t utilitarians, why should courts” -- or for that matter, anyone -- “force them to be?”

Goutam U. Jois, *Can’t Touch This! Private Property, Takings, and the Merit Goods Argument*, 48 S. TEX. L. REV. 183, 250 (2006). In that paper, I argue that an imposition of some preferred set of values is inevitable in system design and that “free market,” utilitarian, or libertarian approaches are no less invasive than so-called “regulatory” or deontological approaches. *See generally id.*

Additionally, recent social psychological evidence suggests that a utilitarian perspective may be based on flawed assumptions about human nature. Martha Nussbaum has argued that the phenomenon of adaptive preferences — whereby individuals’ preferences are not stable over time but rather adapted to the situation around them — means that these revealed “preferences” may not tell us much about what would actually make the individual better off and that preference welfarism, where individuals’ revealed preferences are the basis of policy to increase social welfare, is misguided as a matter of behavioral economics. *See, e.g.*, Martha C. Nussbaum, *Capabilities and Human Rights*, 66 FORDHAM L. REV. 273 (1997).

These compelling arguments have much merit. However, regardless of the implications of psychological evidence on rational choice theory generally (about which much has been written elsewhere; *see, e.g.*, COLIN CAMERER, GEORGE LOWENSTEIN, & MATTHEW RABIN, *ADVANCES IN BEHAVIORAL ECONOMICS* (2003); Amartya Sen, *Rational Fools: A Critique of the Behavioral Foundations of Economic Theory*, 6 PHIL. & PUB. AFF. 317 (1977); Daniel Kahneman, *New Challenges to the Rationality Assumption*, 150 J. INST. & THEOR. ECON. 18 (1994); Jon Hanson & David Yosifon, *The Situation: An Introduction to the Situational Character, Critical Realism, Power Economics, and Deep Capture*, 129 U. PA. L. REV. 152 (2004); Jon Hanson & David Yosifon, *The Situational Character: A Critical Realist Perspective on the Human Animal*, 93 GEO. L.J. 1 (2004)), it is surely agreed that an increase in overall wealth is desirable from a welfarist perspective, however that welfare is measured. In this context, the problems with the utilitarian assumption likely are not damaging to the argument. I propose a system that provides, at a minimum, benefits identical to the current system at lower cost. It is hard to imagine why such a system would be undesirable, even from an anti-utilitarian perspective.

<sup>78</sup> *See generally* POSNER, *supra* note 71.

rule will yield similar benefits at lower cost, it should be preferred to the status quo, as it will increase social welfare by virtually any measure.<sup>79</sup>

I apply this approach in one specific context: when individuals either have first-party insurance to cover the magnitude of their losses or their losses are small relative to wealth. In both of these cases, insuring against the loss is not a policy concern, either because insurance already exists or because it would not be cost-justifiable to purchase first-party insurance. In the latter case, the losses to the victims are relatively small anyway.<sup>80</sup>

It is at this point that there is a gap in the literature. Although scholars adopt a variety of positions on the role of damages, there is no discussion of how to achieve optimal deterrence at lower cost when insurance goals are adequately fulfilled. Although the status quo tort system theoretically yields optimal deterrence, that model is far from approximated in reality, particularly in class action and mass tort cases. In addition, my proposal solves several problems that attend the current system, including uncertainty, the link between harm and compensation, distorted consumption and production incentives, and high administrative costs.

## B. OUTLINING THE THEORY

With the cy pres context and my consequentialist approach to damages in mind, I now fully explicate the special normative theory<sup>81</sup> for ex ante

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<sup>79</sup> It is true that, for optimal deterrence, it does not matter what happens with the money once it is extracted from the defendant; putting the money in a pile and burning it has the same deterrence effect as distributing it to the members of the plaintiff class. However, the latter would presumably yield greater benefits (those that accrue to the plaintiffs) at the same cost (that of establishing liability, assuming no transactions costs). Thus, the distribution to the class would be preferable to burning the money from a social welfare perspective. Of course, there are significant administrative costs involved in distributing money to the class. *See infra* notes 105 - 109 and accompanying text. Therefore, I propose a system of escheat to the state, which would yield deterrence, social welfare benefits, and entail nearly zero administrative costs.

<sup>80</sup> The theory I propose and the analysis I employ are important in their own right. It should also be noted that the argument is generalizable, *see infra* note 99, although I do not do so here.

<sup>81</sup> I use the phrase “special normative theory” with specific meaning. Obviously, the argument explicates a theory that is normative. It is a “special” normative theory because it applies -- at least as explicated in this article -- only where individuals have insurance or the magnitude of their losses is small relative to wealth. I also use the phrase “special normative theory” in this context in contradistinction to Rosenberg’s “general normative theory for collectivized adjudication.” *See* David Rosenberg, *Adding a Second Opt-Out to Rule 23(b)(3) Class Actions: Cost Without Benefit*, 2003 U. CHI. LEGAL F. 19 (2003). The special normative theory here assumes a type of collective adjudication, although not all affected members need necessarily be part of the plaintiff class. Since, on average and over time, all members of society will be equally exposed to all risks, all members of the “class” -- i.e., the entire citizenry -- would receive benefits and bear the risks.

compensation in cases where an individual is fully insured or losses are small relative to his wealth. In those cases, damages -- in proportion to the risk of harm that society faces -- should be assessed against the tortfeasor, and those damages should be paid to the state.<sup>82</sup> Doing so, I submit, will yield a series of benefits and increase social welfare.

The problem I address in this section is quite common. Even if they have first-party insurance or magnitudes of their losses are small, individuals are regularly exposed to risks of harm and as a result experience a net welfare loss. These losses might take the form of so-called “exposure only” victims (who have not been harmed in a physical sense but nonetheless experience disutility from the exposure to the potential tort) as well as “low-magnitude” victims. But even if losses are small, the loss to society could be significant. Assume that a popular widget carries with it only a 0.01% risk of harm to any given individual, and the magnitude of that harm (if realized) would on average cause a loss of utility of \$10,000. If the risk is evenly distributed among a population of a million, each individual would only face an expected loss of one dollar. The loss to society, however, would be one million dollars — no insignificant sum.

The loss would, in turn, lead to distorted consumption and production choices. It is fairly widely accepted that it would be socially optimal for the producer of this widget to internalize the cost of expected liability.<sup>83</sup> When producers internalize the costs of the social harm caused by their products, they will produce a lower number of widgets and, as a result, reduce the average risk to society; without cost internalization, the widgets would get overproduced. Additionally, without cost internalization, citizens will overconsume the widget. If expected liability was not incorporated into price, the widget would be inefficiently cheap.<sup>84</sup>

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<sup>82</sup> Limited versions of a theory like this -- although without an explicit social welfare objective -- have been floated in the past. The Kansas legislature entertained, but did not pass, a proposal to have all *punitive* damage awards transmitted to the state. See S. 96, 2005 Reg. Sess. (Kan. 2005). Galligan has proposed a system of “public torts” for the types of harms that, *ex post*, affect large portions of society as a whole. See *infra* notes 108 - 109 and accompanying text.

<sup>83</sup> See, e.g., Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499, 533 (1961); see also *id.* at 514 (“Not charging an enterprise with a cost which arises from it leads to an understatement of the true cost of producing its goods; the result is that people purchase more of those goods than they would if their true cost were reflected in their price”).

<sup>84</sup> *Id.* at 514. Note that the distributive aspects of the problem are irrelevant to the deterrence (cost-internalization) aspects. In other words, to achieve optimal deterrence, the tortfeasor should be made to pay the cost he is externalizing on society. Much like a Pigouvian tax, what “society” does with that money is irrelevant from a deterrence perspective. Cf. ARTHUR C. PIGOU, *THE ECONOMICS OF WELFARE* 134, 192 (4th ed. 1992). See also *supra* note 79 (noting that distribute effects are not relevant from a deterrence point of view). However, different distributive schemes will obviously have different impacts on social

The current tort system provides a way to deal with the two problems noted above: the promise of ex post compensation. If the widget blows up, I can hire a lawyer and sue the widget company (WidgetCo) to recover my \$10,000. The contingency fee arrangement gives entrepreneurial lawyers an incentive to seek out and bring such lawsuits.<sup>85</sup> To capitalize on economies of scale, attorneys will create a class of plaintiffs (in this example, the 100 people affected by the defective widget) and litigate the matter as a class action. In doing so, they will extract the full \$1 million in damages from WidgetCo, creating the proper deterrence signal. Liability costs are incorporated into the price of the widget, and WidgetCo will make fewer widgets in the long run. It would appear, then, that the socially-optimal result is reached.

Unfortunately, this theoretically neat description of the tort process has some limitations. First, although the promise of ex post compensation offsets the individuals' losses, it is inextricably tied to getting harmed in the first place. Citizens have to bear the risk of the widget blowing up in the hopes of being compensated after the fact. Additionally, the tort system provides no guarantee of compensation. Even if they have a strong case on the merits, plaintiffs may be procedurally-barred from bringing suit or otherwise lose on technical grounds. There may be good reasons for such a system, but the fact would remain that tortfeasors would be externalizing costs onto society at large.

These two forms of uncertainty are especially problematic in the aggregate if a large number of people are risk-averse (and we have good reason to believe that they are<sup>86</sup>). The risk-averse individuals might simply not purchase the widget at all because of the risk posed to them and the uncertainty of compensation, even though, in theory, they should be indifferent between the status quo and an expected harm of \$1 with expected recovery of \$1. If the number of risk-averse individuals is high enough, society could experience a significant aggregate welfare loss; a number of people would not be using the widget and foregoing the attendant

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welfare. I assume here that a plan that delivered increased compensation to tort victims would increase welfare, all else equal.

<sup>85</sup> See Gilles & Friedman, *supra* note 70.

<sup>86</sup> Findings regarding individuals' aversion to both risks and losses are well documented and quite robust. See, e.g., John W. Pratt, *Risk Aversion in the Small and the Large*, 32 *ECONOMETRICA* 122 (1964) (discussing risk aversion); Daniel Kahneman, Jack L. Knetsch, & Richard Thaler, *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 *J. ECON. PERSP.* 193 (1991) (discussing loss aversion). Thus, although some people might not be risk averse and might even be risk-preferring, see, e.g., Charles A. Holt & Susan K. Lowry, *Risk Aversion and Incentive Effects*, 92 *AM. ECON. REV.* 1644 (2002) (discussing contexts in which some individuals exhibit risk-preferring behavior), a general tendency toward risk aversion means that some significant number individuals is not taking risk that a "rational," i.e., risk-neutral, person would take.

benefits. Together, uncertainty and the link between harm and compensation serve to distort consumption and production incentives.

Second, the tort process involves extremely high administrative costs.<sup>87</sup> If the claim is prosecuted as a class action (as would probably be required under the status quo, since all of society's members bear the risk), the costs are even higher, including costs of identifying the plaintiff class, administering the fund of money recovered, and distributing the money to plaintiffs when (if) they come forward. Additionally, in many cases, all of the members of the class cannot even be identified, leaving significant amounts of money undistributed at the end of the process.<sup>88</sup> All of these costs would be avoided in a system with direct payment to the state.

### C. ELEMENTS OF THE MODEL

#### 1. *Ex Ante Perspective*

There are two ways in which the theory requires an ex ante perspective. Both are hypothetical, and neither is achieved in the real world. However, both are sufficiently approximated in the real world that the theory is sound. First, the theory requires all individuals to take an ex ante perspective at the policy design stage. Call this the "individual ex ante perspective." Behind something like Harsanyi's or Rawls's veil of ignorance, individuals are essentially asked to select a system for adjudicating "small loss"<sup>89</sup> mass tort claims. In selecting this system, the individual does not know if he will be poor, wealthy, or anything else. Second, the system itself takes an ex ante view, meaning that the system should be evaluated with regard to how it will perform in the long run, not in the near-term future, when transitional issues would obviously have to be worked out. Call this the "institutional ex ante perspective."

I assume, as Rosenberg and Scanlon argue, that the individual ex ante perspective must take place behind a veil of ignorance "because sound legal policymaking could not be accomplished otherwise."<sup>90</sup> Behind the veil of

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<sup>87</sup> See *infra* notes 105 - 109 and accompanying text.

<sup>88</sup> See generally Forde, *supra* note 7.

<sup>89</sup> See *infra* Part III.C.2 for a fuller description of what I mean by "small losses."

<sup>90</sup> David Rosenberg & John Scanlon, *Class Actions: To Be or Not To (b)(3)?*, 24 MISS. COLL. L. REV. 153, 160 (2005). They go on to say

Since a decision-maker standing behind the veil of ignorance could be anyone with a probability corresponding to the actual demographics of the world to come, the individual's choice of legal system under those conditions of uncertainty will maximize his or her expected welfare by maximizing the welfare of everyone across all states of the world. This behind-the-veil-of-ignorance perspective is thus compelling not only because it is the only decision point for making rational choices that can maximize overall welfare, but also because those choices express common, unprejudiced interests. It is these common,

ignorance, the individual does not know which of the myriad small losses he will bear in reality. He may, for example, be a millionaire who loses a small amount in a stock fraud scandal, or a low-income migrant worker who works under slightly suboptimal conditions, or one of any other people who faces the risk of a small loss. (However, in this special context, the individual knows that the loss he suffers, if any, will be small relative to wealth or that he has first-party insurance.)

Ex post, the individual would very likely -- because of self-interest, situational pressures, or otherwise -- to seek to maximize the amount of his recovery after bearing some loss. For example, the defrauded investor will want very high recovery in his securities class action. But ex ante, he does not know if he will be an investor or a migrant worker; his concern is with maximizing expected recovery across all lawsuits, so that the maximum recovery is achieved regardless of the state in which he ultimately finds himself.

I begin with a few basic (and I hope uncontroversial) assumptions. First, I assume that the individual behind the veil would want optimal deterrence.<sup>91</sup> On this score, I assume that the individual would prefer a system that provided more compensation to one that provided less (all else equal). All individuals would prefer a system where they are likely to share in the recovery, and ex ante, all individuals expect to share equally in the provision of benefits by the state.<sup>92</sup> This assumption -- of an ex ante,

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unprejudiced interests--not the self-interested preferences that arise once the future is revealed--that will provide a reliable as well as respected basis for legal policymaking.

*Id.* I adopt that line of reasoning here.

<sup>91</sup> This assumption has been called into question. See Cass R. Sunstein, David Schkade, & Daniel Kahneman, *Do People Want Optimal Deterrence?*, at <http://ssrn.com/abstract=166168> (last visited April 21, 2007). However, Sunstein et al. approach the question from an ex post perspective -- that is, whether people, if asked about a particular case, would express a preference for the solution that would yield optimal deterrence. Perhaps predictably, people did not express preferences for optimal deterrence: for example, they did not agree that a delinquent taxpayer should pay higher penalties when the odds of prosecution were low or that a judge should set aside punitive damage awards for egregiously reckless conduct when odds of prosecution were nearly 100% -- both outcomes that would be required if optimal deterrence was the goal. See *id.* at 9-11.

However, the question for system design is whether the answer would change from an ex ante perspective. Sunstein et al. believe that a system that provided optimal deterrence would be seen as unfair by the populace. See *id.* at 17-18. However, the proposal here does not deviate significantly from the status quo. Indeed, it provides many if not all of the benefits the current system provides in theory, but at lower cost and with better deterrence. Although there may be objections to the idea of optimal deterrence in particular cases, it is not obvious that Sunstein et al.'s critique applies in this context, when the deterrence gain comes at low (perhaps even negligible) cost.

<sup>92</sup> For problems of regulatory capture, see George Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971), inadequate representation, or other deficiencies in the political process, the state's actions may not actually deliver benefits to all citizens. For that reason, I suggest the possibility of distributing the recovery from litigation

behind-the-veil perspective -- is what leads to the conclusion that individuals would prefer that compensation, at least in small loss cases, escheat directly to the state.

I also use the phrase “ex ante perspective” in another regard. I have loosely referred to the fact that tort victims will be compensated ex ante. However, this is not strictly true: after a given product fails or otherwise creates a loss to society, liability will have to be established and litigation will ensue. This litigation could take several forms, but for simplicity’s sake, let us assume that the claim is prosecuted as a class action. The tortfeasor would actually make payment after liability was established (“ex post”) in this particular case.

However, over time, the government would receive a stream of revenue from the various litigations on a regular basis. Thus, each year, the government would disburse these funds to the citizenry in the form of lower taxes, higher social services, or a direct payment to the citizenry. Over time, these benefits would essentially compensate individuals ex ante for the risks they face from the various torts that they may suffer. As the risks and payments continue over time, one would receive a predictable amount of money from the state each year.

In short, the special normative theory assumes an individual ex ante perspective, under which the participant does not know which of various possible worlds he will be in. However, because he knows he is in a situation of small losses, he will choose a regime that compensates him on average for all expected losses from future torts. Second, the theory adopts an institutional ex ante perspective, in which the system is judged by its performance in delivering benefits over time, even though in each individual case the tortfeasor actually makes payment ex post. Under such a regime, each individual would essentially be compensated ex ante for expected tort losses in the future.

## 2. *Small Losses (Full Insurance)*

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in the form of cash, either with direct checks to all citizens or as a fully refundable tax credit. *See infra* note 106. The former may even be somewhat anti-regressive since not all poor people file income taxes.

Again, this is limited to the context of small losses. A second-order assumption here is that the question of any deontological entitlement to sue can be bracketed because, to the extent that such an entitlement exists (in reality) or can be justified (in theory), it is nonexistent or negligible in the context of small losses, basically because people do not have an interest in prosecuting relatively small claims. *Cf., e.g.,* Jean Braucher, *An Informal Resolution Model of Consumer Product Warranty Law*, 1985 WISC. L. REV. 1405, 1450-51, 1455 (1985) (noting that most people do not even complain to sellers about potentially problematic transactions, let alone prosecute a civil claim, and that they contact an attorney only approximately seven percent of the time); *see also* Leon E. Trakman, *David Meets Goliath: Consumers United Against Big Business*, 25 SETON HALL L. REV. 617 (1994).

I use the phrase “small loss” very specifically here, as shorthand for the formulation, “Where harmed parties have first-party insurance to cover their loss or the magnitude of the loss is small relative to their wealth.” The “small loss” formulation is important. In the widget example earlier, for example, each individual suffers an expected loss of only \$1, a magnitude that is probably negligible for almost all members of the populace. However, the theory can apply with equal force in other contexts. For example, in the securities class action context, a stockholder may lose hundreds or even thousands of dollars as a result of fraud. However, so long as the individual’s loss is small relative to his overall wealth, the theory outlined here still applies.

The theory applies because in the context of relatively small losses or first-party insurance to cover the magnitude of any such loss, the insurance function of tort law is not relevant. There has been vigorous debate as to whether tort law should be used to insure against losses at all. Opponents of using tort law to insure against non-cost-justifiably-preventable harms argue that tort law frustrates risk diversification and exacerbates problems of adverse selection and moral hazard,<sup>93</sup> that it cannot incorporate copayments,<sup>94</sup> and that it leads to unwanted overinsurance and as a result depresses demand for consumer goods.<sup>95</sup>

However, other scholars have argued that third-party insurance through tort liability is preferable to first party insurance because it sorts insureds into more homogenous risk pools (which are as a result more efficient),<sup>96</sup> that it optimizes manufacturers’ care and activity levels,<sup>97</sup> and that compensation through tort can yield optimal deterrence while satisfying unmet demand for insurance against nonpecuniary losses.<sup>98</sup>

In the end, tort law may or may not be effective and efficient as an insurance mechanism. However, by assuming that individuals either have or do not need insurance, these questions are off the table. This is not as outlandish as it might seem at first glance. Individuals already generally have first-party insurance to cover many losses to their life, health, or

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<sup>93</sup> See, e.g., Richard A. Epstein, *Products Liability as an Insurance Market*, J. LEGAL STUD. 645, 648-53 (1985).

<sup>94</sup> See, e.g., George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521, 1553 (1987).

<sup>95</sup> See, e.g., Alan Schwartz, *The Case Against Strict Liability*, 60 FORDHAM L. REV. 819, 820, 832-40 (1992).

<sup>96</sup> See, e.g., Steven P. Croley & Jon D. Hanson, *What Liability Crisis? An Alternative Explanation for Recent Events in Products Liability*, 8 YALE J. ON REG. 1, 109-10 (1991).

<sup>97</sup> See, e.g., Jon D. Hanson & Kyle Logue, *The First-Party Insurance Externality: An Economic Justification for Enterprise Liability*, 76 CORNELL L. REV. 129, 137 (1990).

<sup>98</sup> See, e.g., Steven P. Croley & Jon D. Hanson, *The Nonpecuniary Costs of Accidents: Pain-and-Suffering Damages in Tort Law*, 108 HARV. L. REV. 1878, 1791-93 (1995).

property. While there are undoubtedly contexts in which individuals do not carry first-party insurance -- pain-and-suffering losses, for example -- those situations are also likely not to involve losses that are small relative to the individual's wealth.<sup>99</sup> As a result, in those cases, the theory advocated here would not be applicable.

Finally, in this context, individuals are likely suffering losses but not bringing legal claims. Trakman writes that

individual consumers generally lack the resources to sue big business for their modest losses arising daily from illegal bank charges, unjustified insurance premiums, and product defects. Deterred by the cost of individual suit and the likelihood of winning meagre [sic] damages, most consumers do not bother to seek individual justice. In the meantime, banks, insurance companies, and auto manufacturers make millions of dollars in profit by breaching obligations towards masses of their customers.<sup>100</sup>

If individuals are not pursuing the valid "small loss" claims, then this form of compensation becomes even more important, because it delivers benefits to citizens that they are currently foregoing.

### 3. *Infinite Time Horizon*

This theory will not work in practice if implemented tomorrow. However, it will work quite well five years from now. In other words, the theory assumes an infinite time horizon and longitudinal application of the theory. This assumption dovetails with the requirement of an institutional ex ante perspective. Consider the following example.

If a group of migrant workers were being mistreated (again, in a way that entailed small losses), application of the theory would counsel payment of damages to the state, which might then build better roads. It is unclear

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<sup>99</sup> Although most individuals might have first-party insurance to cover, for example, health risks, not everyone does. It is an assumption of the theory that everyone would have such insurance. There may be ways to correct this problem. For example, if nearly all individuals had first-party insurance, the government might adopt the theory as a general matter but pay out individualized claims for the pecuniary losses of the uninsured. This could be generalized into a system in which all recoveries from tort liability are paid into a social insurance fund such as Social Security. My argument here is more limited, but it should be noted that expanded (and expansive) applications are certainly possible and may well be desirable. The theory described here could be characterized as the first step toward a broader application of these principles.

<sup>100</sup> Leon E. Trakman, *David Meets Goliath: Consumers United Against Big Business*, 25 SETON HALL L. REV. 617 (1994).

why this should be the case, as a matter of either justice or social welfare: I benefit from the better roads, but the workers had to endure substandard conditions in order for me to do so.

However, with an infinite time horizon and the individual ex ante perspective described earlier, the problem is exposed as illusory. This year, the workers might suffer aggregate losses of \$10,000 and only receive benefits of \$1,000. However, next year, they may suffer no loss at all and yet receive benefits of \$1,000. Over time, these costs and benefits will approximate average risk that all individuals in society face from all of the risks that result in small losses. Although the defendant's payments from each individual loss will not accrue solely to the individuals who were exposed to the harm, over time, all individuals will be compensated for all of the small loss risks that they face.

This demonstrates how the institutional ex ante perspective and the infinite time horizon complement one another. The former requires that the system be designed with a view toward compensating people ex ante, on average. The latter requires viewing the system over time, not with regard to any individual cases. It is the infinite time horizon that makes it possible, as a conceptual matter, to compensate individuals ex ante.

#### D. BENEFITS OF THE THEORY

The theory has the same general benefits as escheat in the cy pres context, although they are more robust when the theory is applied fully. Specifically, it corrects problems of uncertainty, eliminates the link between harm and compensation, corrects distorted consumption and production incentives, and reduces high administrative costs.

I have referred a few times to the link between harm and compensation under the status quo. My proposal decouples the two, and this is perhaps the most important conceptual contribution of the theory. Thus, whether or not an individual buys the risky widget, the benefits of the expected liability will accrue to him. This is a benefit in its own right; it is even more pronounced if individuals are risk averse. The risk-averse citizen will receive the benefit of the money paid to the state regardless of whether he engages in the risky activity or not. To the extent that risk aversion deters people from taking actions that they otherwise might (and that might otherwise be beneficial to society), the system of ex ante payments corrects for this limitation by creating a situation in which people can act *as if* they are risk-neutral. As a result, they will be more likely to buy widgets they otherwise would not have bought (up to the "risk aversion margin"), creating a net benefit to society.

In the cy pres context, I proposed that residual funds escheat to the state. That does not fully achieve the decoupling I describe here, because at

least as an initial matter, compensation is linked to harm. Therefore, the cy pres proposal approximates, but does not achieve, this benefit. Full recognition of this benefit is the primary difference between the cy pres policy proposal and the fuller theory.

Ex ante compensation also eliminates the free-rider problem. Under the current system, the deterrence benefits accrue to all members of society but the costs of achieving that deterrence are borne by a few -- that is, borne by the members of the plaintiff class.<sup>101</sup> In such a system, all individuals have an incentive not to bring the action, because they know that if someone else brings the action, they will receive the benefits of deterrence and whatever compensation is paid to class members. This problem is eliminated under my proposal, because compensation is a certainty. The current system entails significant uncertainty, meaning that those who invest time and effort in bringing the case may never see any recovery at all. With the uncertainty eliminated, there is a greater incentive to bring the suits in the first instance.<sup>102</sup>

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<sup>101</sup> Though the plaintiffs' attorneys' compensation might come from the class as a whole, the lead plaintiffs must still expend time and energy in bringing the case. They are usually compensated for this extra effort, *see, e.g.*, Notice of Class Action Settlement and Hearing, *McArthur v. Spring St. Networks, Inc.*, No. 100766/04 (N.Y. Sup. Ct., N.Y. Co. ) ¶ IV.B.3 (payment of \$2,000 to lead plaintiff), but it is unclear whether this "bonus" is sufficient to make bringing suit worthwhile. In any event, this would not be an issue at all under the proposed system.

<sup>102</sup> I assume for the sake of convenience that matters prosecuted as class actions would still have to meet the current requirements of Rule 23 (including commonality, typicality, predominance, etc.), but this is not necessary. The current insistence on representative lead plaintiffs as a component of due process is irrelevant from the deterrence perspective. As Richard Epstein writes, we could imagine that

A's rights were violated but that B has the right to sue. Indeed, if B were an ideal claimant and A were hopeless at litigation, then this odd regime would have some real attractiveness not only for the Bs of this world, but for the entire system as a whole. The defendant cares not one whit *who* gets his money, but only about the likelihood and magnitude of payment. Let B be the perfect professional plaintiff, then these defendants will face higher liabilities, and thus will take greater steps to avoid harm. They will know a similar fate that awaits them from violating the rights of other individuals. Accordingly, they will refrain from the deliberate invasion of these rights and will take care to avoid the accidental violation of these rights as well. The greater security in the person, in the protection of property, in the performance of contracts is enjoyed not just by the Bs of the world, but by the As of the world as well. They might be quite pleased to be stripped of their rights, so long as they believe that their substantive rights will be protected by others that bring suit in the event of loss.

Richard A. Epstein, *Class Actions: The Need for a Hard Second Look*, Manhattan Institute's Civil Justice Report No. 4, at 2 (March 2002).

Third, the proposed system is anti-regressive. Under the current system, a rich person and a poor person might buy the same \$25,000 car.<sup>103</sup> Assume that the car carries with it some risk, and that risk premium (in the form of the manufacturer's expected liability) is a function of the price. Both the rich and poor person would have paid the same risk premium -- placed the same bet, so to speak -- but under a system of ex post compensation, the rich person would recover more money under the status quo because he suffered damage to more expensive items, forewent higher wages, &c. However, ex ante, both the rich and the poor person placed exactly the same bet with exactly the same chance of payoff. It is not clear why the former should get a higher payout on his bet than the latter.<sup>104</sup>

Finally, since ex ante payment to the state involves far fewer administrative costs, there is a net benefit to society. At a minimum, the same deterrence signal is transmitted to the tortfeasor as happens under the current tort system, but that deterrence is achieved at lower cost, viz., the difference between the administrative costs under the current system and costs under the proposed system. To the extent that this system delivers benefits better than the current system at lower cost, it is superior.

As a friend from the Cato Institute wrote, "Despite my libertarian leanings, I'll concede that the government is very efficient at raising revenue and distributing checks."<sup>105</sup> If the goal of a system is to compensate people ex ante for the risks that they face, then it is hard to imagine a system that entails fewer administrative costs than one in which the amount of a recovery would go directly to the state. The state could then distribute the benefit to its citizens in the form of lower taxes, higher benefits, or both.<sup>106</sup> This aspect of the theory is especially beneficial

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<sup>103</sup> If it seems dubious that both a rich and a poor person would buy the same car, feel free to think of another example: they may, for example, own the same risky television or the same toaster oven. There have been problems with the Nintendo Wii game system's controller, see *Nintendo Recalls Straps for Wii Controller*, CONSUMER AFFAIRS ONLINE, at [http://www.consumeraffairs.com/news04/2006/12/nintendo\\_recall.html](http://www.consumeraffairs.com/news04/2006/12/nintendo_recall.html) (last visited April 23, 2007), on a system that was retailing for \$249, *id.*, something that relatively low- and relatively-high income people could afford. Indeed, a dent in the wall caused by a flying Wii controller (as a result of the defective strap) might be just the kind of injury where losses are small relative to wealth but sizable in the aggregate.

<sup>104</sup> It may be that the rich person has suffered greater harm and not compensating him for them would leave a deadweight loss. However, if the individual has full insurance or the loss is small relative to his wealth, this should not pose a problem.

<sup>105</sup> E-mail from Tom Firey, Cato Institute, to Goutam U. Jois, Harvard Law School, April 19, 2007 (on file with author).

<sup>106</sup> There are a variety of ways this might be done. The government might actually write every citizen a check for some amount of money (the "Tort Compensation Payment," perhaps, or something that sounds sexier). Of course, social benefits could be increased as well -- by building roads, schools, etc. The cheapest alternative might be to give every citizen a fully refundable tax credit in the amount of the payments received that year.

because, in the class action context, “expenses of administering the settlement, are large.”<sup>107</sup> Even if the costs of litigation remained exactly the same, the theory would involve no cost in administering the settlement or judgment.

In a slightly different context, Galligan argues for an expanded concept of “public torts,” in which tortfeasors would be liable to governmental entities for costs the government incurs because of the injuries the tortfeasor inflicted on citizens.<sup>108</sup> In that context -- one that is similar, but not identical, to the argument here -- Galligan writes that

[t]he costs of notifying class members of their rights and of the progress of the suit, as well as the costs of the distribution of the proceeds of the suit, are present in class actions [as conducted under the status quo] but not in the public tort suit. In the public tort suit, there is no problem with certification, opt-outs, or complex distribution procedures.<sup>109</sup>

Similarly, the theory described here avoids those same problems. There are no questions of fund administration, distribution, etc.; class members do not have to be notified after the litigation; and members of the public do not need to take any affirmative action to share in the recovery. At a minimum, the proposed system eliminates all post-litigation administrative expenses on the part of fund administrators, the parties, and the court.

## E. POTENTIAL APPLICATIONS

### 1. Tort Law

Earlier, I outlined a potential application of the special normative theory to tort law. In that example, a popular widget carried with it only a 0.01% risk of harm to any given individual, and the magnitude of that harm (if

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<sup>107</sup> Janet Cooper Alexander, *Rethinking Damages in Securities Class Actions*, 48 STAN. L. REV. 1487, 1501 (1996); see also Deborah R. Hensler, *Revisiting the Monster: New Myths and Realities of Class Action and Other Large Scale Litigation*, 11 DUKE J. INT’L & COMP. L. 179, 204 (noting “the costs of notice and settlement administration”);

<sup>108</sup> Thomas C. Galligan, *Deterrence: The Legitimate Function of the Public Tort*, 58 WASH. & LEE L. REV. 1019 (2001).

<sup>109</sup> *Id.* at 1033. Galligan also points out that some people are morally averse to the “windfall” that some plaintiffs may recover through punitive damage awards, even though those awards may be necessary for optimal deterrence. *Id.* He notes that when money is paid directly to the state, that moral qualm probably disappears, because “the government would, by definition, use the recovered funds for public purposes subject to the pressures and controls of the democratic process.” *Id.* I do not dwell on moral objections to punitive damages, but the advantage of Galligan’s system applies to my theory as well.

realized) would on average cause a loss of utility of \$10,000. If that risk were evenly distributed among a population of a million people, each given individual would only face an expected loss of one dollar. The loss to society, however, would be one million dollars — no insignificant sum.

Under the theory outlined here, some individual would bring suit against the widget company. That suit would probably be prosecuted as a class action. However, it is not really necessary for purposes of the theory that it actually be; instead, all that is necessary is that the manufacturer face liability for the total magnitude of the harms caused by its product.<sup>110</sup>

In any case, class action or no, the manufacturer would eventually be liable for some amount of money to cover the harms caused by its product. Under the current system, extensive time, money, and effort would then be expended to distribute the funds to all members of the plaintiff class, and yet inevitably, “[i]n virtually every class action, there remains a reserve fund after all claims and expenses have been paid.”<sup>111</sup>

Under the theory proposed here, all money would escheat directly to the state’s treasury, so there would be no cy pres problem. On average, all individuals would expect to benefit from money in the state coffers, and on average, all individuals faced an equal ex ante risk of being harmed by the product. The decoupling of harm and liability would correct consumption and production incentives, and the administrative costs of identifying and distributing funds to the class would be eliminated. This is the most straightforward application of the special normative theory for ex ante compensation.

## 2. Corporate Law

The theory’s application is not limited to tort law. Imagine that a company’s stock is selling for \$100. Assume that the company is relatively poorly managed and there is a higher chance of stock loss from fraud or other mismanagement. This is not dissimilar to the tort example earlier; the widget described poses a risk of harm to the individuals who buy it, just as the stock here poses a risk of financial harm to those who purchase it.

When the company engages in some malfeasance, its investors likely will bring some sort of class action under the securities laws. When they do, the money is usually distributed to shareholders. Instead, under the theory expounded here, the money should escheat to the state.

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<sup>110</sup> Because of the current state of the law, the claim would most likely be a class action. See *infra* Part IV.C (discussing doctrinal difficulties) for a discussion of how my theory interacts with current rules requiring particularized harm, etc.

<sup>111</sup> *In re Folding Carton Antitrust Litig.*, 557 F. Supp. 1091, 1104 (N.D. Ill. 1983), *aff’d* 744 F.2d 1252 (7th Cir. 1984), *cert. dismissed*, 471 U.S. 1113 (1985).

Consider the benefits of the theory outlined earlier. First, there are risk-averse individuals who may not buy this particular company's stock -- or invest at all -- because they fear the possibility of losing their money. The status quo method by which they may recover their money is an uncertainty. As a result, these individuals are likely to prefer the money they hold today to the risk and uncertain reward later. These individuals would be more likely to invest if the money escheated to the state because they will have been compensated *ex ante* for their later losses. Again, because compensation and harm are decoupled, individuals' consumption and production incentives (in this case, the pricing of the stock and the willingness of people to purchase it) will not be skewed as an initial matter.

Finally, and perhaps most important in the corporate context, the high administrative costs of distribution would be eliminated. In all of these cases, money must be distributed to the plaintiff class, a task that can consume extraordinary resources in terms of time and money. Instead, if the money directly escheated to the state, those administrative costs would be reduced greatly. That would in turn suggest that the recovery from the fund would be higher, meaning that the compensation that individuals would get for their losses would be higher.<sup>112</sup>

The corporate law context provides a variety of situations in which this theory might be applied. Funds recovered from actions brought under the securities laws, shareholder derivative suits, and even disgorgements pursuant to the Sarbanes-Oxley Act -- which are currently placed into a "fair fund" for investors<sup>113</sup> -- could escheat to the state so as to compensate citizens *ex ante* for their losses.

This claim may make less intuitive sense than the tort case where, by stipulation, all members of society faced an equal risk of harm. Here not all members faced an equal risk: only those who were already investors had any risk of losing money; the rest of the populace did not. At this point, it is important to emphasize the individual *ex ante* perspective.<sup>114</sup> After I become an investor and buy stock, I know that I am at risk for losses from corporate malfeasance but probably not from unsafe working conditions for migrant workers. However, at the system design stage, behind the veil, I do

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<sup>112</sup> See *supra* notes 105 - 109 and accompanying text (describing the high administrative costs in this context). It is important to note that as a matter of deterrence, it is not relevant whether individuals get high or low payouts on their claims. However, when those who faced the risk on average receive compensation, they will be more likely to engage in the activity in the future (because they know that if they are harmed, they will be compensated). If they receive that compensation *ex ante*, they will be even more likely to engage in those productive and consumptive activities for the reasons described above. See *supra* Part III.D (benefits of the theory). To the extent that a given system better compensates those harmed by a tortfeasor, all else equal, it will increase social welfare.

<sup>113</sup> See *id.*

<sup>114</sup> See *supra* Part III.C.1.

not know that. The theory outlined here compensates all individuals ex ante for the menu of risks they do or will face, even if they are not “compensated” in this particular case (as we currently think of the term).

It should be clear that this theory can apply to a variety of cases, not just the prototypical “mass tort.” Indeed, the quote regarding undistributed funds<sup>115</sup> was from an antitrust action, and the theory applies just as well in that case. In any case where losses are small relative to wealth or individuals have insurance, the theory finds robust application.

#### IV. COUNTERARGUMENTS, RESPONSES, AND COMPATIBILITY WITH A DEONTOLOGICAL PERSPECTIVE

In this section, I explore some counterarguments, provide responses, and take a bit of a detour to discuss the compatibility of the special normative theory with a deontological perspective. The counterarguments I explore are of three types: first, critiques of the rational choice assumptions that underlie economic theory and, implicitly, my theory; second, the philosophical critique of the theory for adopting a utilitarian perspective; and third, doctrinal and practical difficulties posed by the theory I advocate.

##### A. BEHAVIORAL ECONOMICS

In a move that is probably a bit unusual, I will respond to these counterarguments before raising them. The response is simple: whatever procedural or substantive impediments there are, to the extent that they challenge the normative conclusions, they equally afflict the current system. To the extent that the special normative theory delivers benefits at lower cost, it must be superior.

For example, there is the problem that all risks may not be accurately assessed.<sup>116</sup> If risk perception is colored by cultural factors, values, or other mediating influences, then effective risk regulation is impeded.<sup>117</sup> However, it is not clear that the proposed system exacerbates any of those problems. In each individual case, the tortfeasor is paying the costs of accidents ex post, that is to say, after the accidents have already occurred. In such a situation, it should be clear what the harm is from the tortfeasor’s product.

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<sup>115</sup> See *supra* note 8 and accompanying text.

<sup>116</sup> See, e.g., JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES (DANIEL KAHNEMAN et al. eds., 1982); Yuval Rottenstreich & Christopher K Hsee, *Money, Kisses, and Electric Shocks: On the Affective Psychology of Risk*, 12 PSYCHOL. SCI. 185 (2001).

<sup>117</sup> See generally Daniel M. Kahan & Donald Braman, *Cultural Cognition and Public Policy*, available at <http://ssrn.com/papers=746508> (last visited April 30, 2007); Daniel M. Kahan, Paul Slovic, Donald Braman, & John Gastil, *Fear and Democracy: A Cultural Evaluation of Sunstein on Risk*, 119 HARV. L. REV. 1071 (2006).

Those initial assessments may be wrong -- for example, perhaps there is a long latency period after which new claims might arise -- but then another round of litigation could ensue. As opposed to ex ante regulation through a government agency or otherwise, the method of ex ante compensation assumes that payment will be made following litigation, after the harms have been identified. Although there may be errors in identifying and in addressing those harms, those errors are not any more pronounced in this system than in the status quo.

Same, too, with the problem of adaptive preferences. Harsanyi suggested that “preference utilitarianism is the only form of utilitarianism consistent with the important philosophical principle of *preference autonomy* . . . the principle that, in deciding what is good and what is bad for a given individual, the ultimate criterion can only be his own wants and his own preferences.”<sup>118</sup> However, the phenomenon of adaptive preferences suggests that preference utilitarianism is a faulty framework. As Sen notes, “[q]uiet acceptance of deprivation and bad fate affects the scale of dissatisfaction generated, and the utilitarian calculus gives sanctity to that distortion.”<sup>119</sup> Nussbaum concludes that “[t]his phenomenon of ‘adaptive preferences’ -- preferences that adjust to the low level of functioning one can actually achieve -- has by now been much studied in the economic literature, and is generally recognized as a central problem, if one wants to use the utilitarian calculus for any kind of normative purpose in guiding public policy.”<sup>120</sup>

Those and other critiques address the assumption that revealed preferences tell us something about utility. Harsanyi writes that the individual’s own wants and preferences are the only measure of welfare. However, it might be that those wants and preferences are not stable over time and are shaped by the external situation. If this is so, then preference-satisfaction would be a poor measure of utility.

But my theory does not go that far. The only utilitarian assumption that the theory makes is that people would prefer more money to less, all else equal. In theory, the status quo tort system could deliver optimal deterrence. My proposal yields optimal deterrence but also offers more money to citizens on an ex ante basis and provides a series of other benefits.<sup>121</sup> To the extent that the status quo tort system suffers from the

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<sup>118</sup> John C. Harsanyi, *Morality and the Theory of Rational Behavior*, in UTILITARIANISM AND BEYOND 39, 39 (Amartya Sen & Bernard Williams ed., 1982).

<sup>119</sup> Amartya Sen, *Rights and Capabilities*, in MORALITY AND OBJECTIVITY: A TRIBUTE TO J.L. MACKIE 130 (T. Honderich ed., 1985).

<sup>120</sup> Martha C. Nussbaum, *Capabilities and Human Rights*, 66 FORDHAM L. REV. 273, 283 (1997) (internal citation omitted).

<sup>121</sup> See *supra* Part III.D (benefits of the theory).

same limitations -- and there is no reason to think it does not -- my system is superior, in that it delivers greater benefits at identical cost.

The counterargument may come that my theory assumes that people will be better off being compensated on average ex ante rather than with tailored damage awards ex post. Leaving aside the question of whether recovery would be lower in the second world,<sup>122</sup> it could be argued that my position is essentially one of rule utilitarianism, that the system will be better off with ex ante compensation than with ex post. I take this possibility up in the next section.<sup>123</sup> For now, it is enough to say that I do not make assertions about what types of choices or situations will increase individuals' utility. The theory does not delve into why, how, or under what circumstances people's choices increase their welfare; the theory gives people more money and leaves the rest to them.

## B. DEONTOLOGY

My argument explicitly adopts a utilitarian perspective. However, even the purest form of utilitarianism, in which all people are free to choose whatever makes them happiest,<sup>124</sup> involves some form of value imposition. To illustrate, one need only consider the example from Posner cited earlier<sup>125</sup> -- people may not believe in welfare maximization, yet the utilitarian calculus assumes that is what is important.

Of course, utilitarianism can be easily reframed as deontological. The rule-utilitarian's position that liberty ought to always be maximized<sup>126</sup> rests on an assumption that doing so will increase everyone's well-being in the long run. That assertion is not falsifiable, though, and rule utilitarianism either breaks down into act utilitarianism<sup>127</sup> or is a deontology of its own.<sup>128</sup> A categorical rule that small loss risks should be adjudicated through a collective mechanism could be characterized as deontological, with a commitment to a particular conception of social welfare.

This is all just a matter of framing. My intention is not to be persuasive on the point that my theory, originally framed in utilitarian terms, is actually deontological. It is merely to point out that the lines between the two are at

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<sup>122</sup> It almost certainly would. See *supra* notes 105 - 109 and accompanying text (describing high administrative costs).

<sup>123</sup> See *infra* Part IV.B (deontology).

<sup>124</sup> See, e.g., Harsanyi, *supra* note 118.

<sup>125</sup> See *supra* note 77.

<sup>126</sup> See, e.g., JOHN STUART MILL, ON LIBERTY (Gertrude Himmelfarb ed. 1982) (1869).

<sup>127</sup> See, e.g., Li Feldman, *Libertarianism with a Twist*, 94 MICH. L. REV. 1883, 1895- 96 (1996).

<sup>128</sup> Cf. Simons, *supra* note 63, at 276 - 85 (arguing that the ostensibly consequentialist elements of tort law are better understood in deontological terms).

least a bit blurry, and one is not precluded from accepting the soundness of this theory merely because of a commitment to deontology.<sup>129</sup>

More to the point, it is hard to see how this is any *worse* than the status quo system. Maybe the system somehow limits individuals' autonomy to prosecute separate claims, but in most of these cases (involving small losses or full insurance) people probably are not bringing claims anyway. Individuals rarely even complain about minor problems, let alone bring suit over them.<sup>130</sup> As a result, many tortfeasors do not pay for the harms they inflict and do not see the correct deterrent signal.<sup>131</sup> Even if an individual "right" exists under the status quo, it is going unutilized. My proposal takes something people are not using and gives them a series of benefits in return.

If all relevant elements of the status quo are maintained but at lower cost and with better deterrence, it does not appear that anything has been lost.

One might argue that the system should be redesigned to improve autonomy or some other deontological goal, not deterrence or other consequentialist goals. To this I would simply respond that that any system imposes certain values<sup>132</sup> and the theory outlined here elects one set of values. I do so because I contend that it is philosophically indistinguishable from the status quo while yielding additional benefits. To the extent that it is argued that my system prioritizes one set of values over another, I agree.

### C. DOCTRINAL DIFFICULTIES

There are several practical considerations that arise in the context of implementing the theory outlined here. First, many class actions involve coupons, rebates, or other in-kind judgments. These cases pose the question of whether the actual coupons would go to the state, and if so, what the state would do with them. Second, through this paper, I have spoken loosely of escheat to "the state." The question here is which governmental entity actually gets the money, particularly in multidistrict cases where the tort

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<sup>129</sup> Rosenberg suggests that the fundamental principles of an autonomy-based deontological system are a prohibition on appropriating benefit from others and a prohibition on imposing detriment on others. To the extent that litigants pursued individual claims instead of a collective action as suggested here, they would undercut optimal deterrence (thus imposing detriment on others) and from the potential recovery at the expense of others (thus appropriating a benefit from others). It could be argued that an individual who presses his own claim instead of the collective claim here violates these provisions. Again, the goal is simply to show that there may be more overlap between the utilitarian and deontological positions than initially thoughts.

<sup>130</sup> See Braucher, *supra* note 92.

<sup>131</sup> See Trakman, *supra* note 100.

<sup>132</sup> See generally Jois, *supra* note 77.

might affect several jurisdictions. Third, the proposal implicates the current requirements of Rule 23 and the way class actions are managed.

The first question -- what to do with coupons and the like -- is resolved fairly easily. Even in the case of in-kind settlements, the defendant incurs some cost. Thus, in cy pres cases, the unclaimed coupons, vouchers, discounts, etc., could be liquidated and that dollar amount transmitted to the state. If the theory were implemented in full as proposed in the second part of the paper, then there would be no need for settlements or judgments that involved coupons, rebates, etc. In the full implementation of the theory, this problem is moot.

The second issue is more complicated, although it is one of implementation and does not affect the validity of the theory. Recall that from the individual's ex ante perspective, he does not know whether he will be rich, poor, injured, not injured, etc. Similarly, he does not know what state he will live in. Thus, escheat to the United States Treasury would best accomplish the theory's goals. However, I recognize that this may seem somewhat radical, especially when certain jurisdictions feel a certain connection to localized torts (such as pollution of a stream that causes illness in a defined region). Therefore, alternatively, the fund from each state court class action could go to the state, and every federal or multidistrict fund could go to the U.S. Treasury.

From a defendant company's perspective, doing business across the United States does not mean fifty-one calculations about liability regimes; rather, it means a view of "average liability" across all liability regimes. Therefore, delivering funds to the federal government makes the most sense. However, not all mass tortfeasors do business nationwide. An alternative formulation would be to divide the fund pro rata between all jurisdictions in which the defendant does business. Practically speaking, however, the money in certain cases will have to go to individual states because, as a matter of federalism, Congress probably would not be able to direct state courts to deposit fund money in the federal treasury. But so long as mass tortfeasors are doing business and estimating across jurisdictions, the more doctrinally correct course would be to deliver the money to the U.S. Treasury in all cases.

The question of delivering money to the states to serve deterrence goals raises a related question: what should be done where the *state* is the defendant? The state itself has to be deterred, but giving money to the state seems to undermine this goal (just as allowing money to revert to a defendant would undermine the deterrence goal). This is not an actual problem if the state simply writes checks to its citizens to distribute the money. In that case, the state actually incurs a cost, and therefore sees a deterrent signal. Obviously, the government could simply raise taxes to make up for the lost money. However, this problem affects any system

where the state is the defendant. In other words, even if the fund were paid out to individual plaintiffs as is done currently, the state could *still* raise taxes to offset its liability. This possibility enables the state to evade the deterrent signal, but having the state write checks to the citizenry will at a minimum serve the ex ante compensation goal.

The third challenge is perhaps the greatest shift from the status quo. Currently, a putative class action has to satisfy the requirements of Rule 23 in order to be successful. Thus, the class action must be superior to individual actions; the lead plaintiff's claims must be typical of those of the class; common questions of law and fact must predominate; and so on.<sup>133</sup> In addition, the Supreme Court has held that each plaintiff must make a showing of individual harm as a result of the tortfeasor's conduct. In the recent *Phillip Morris* case, the Supreme Court held that "the Constitution's Due Process Clause forbids a State to use a punitive damages award to punish a defendant for injury that it inflicts upon nonparties or those whom they directly represent, *i.e.*, injury that it inflicts upon those who are, essentially, strangers to the litigation."<sup>134</sup>

Therefore, it would probably not be possible for a single individual to bring suit and to then make the company pay for the total of *all* of its harms as I suggest -- even if doing so would send the proper deterrent signal at lower administrative cost.

However, I have only assumed that the claim is prosecuted as a class action in this paper for simplicity's sake. This is not the only option. For purposes of the theory, the lawsuit could be an individual action, a *qui tam* action, an action brought by a state, or even one brought by a "private" attorney general and yield the same result. One of these alternative vehicles could be used to avoid the constitutional problem posed by cases such as *Williams*. Nevertheless, from the perspective of my theory, there is no problem with assessing full damages against the defendant.

## V. CONCLUSION

This paper has proposed a sharply different way to approach the role of damages in tort law. Our judicial system tries to compensate victims ex post and tailor their damage awards directly to victims' losses. In contrast, I propose reimaging the role of tort damages. Instead of viewing damages as an individual right to some money ex post, in close tailoring to one's actual loss, I propose compensating individuals ex ante with a view to the average risk borne. This approach would apply in cases where individuals have full insurance or where their losses are small relative to wealth.

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<sup>133</sup> See Fed. R. Civ. P. 23.

<sup>134</sup> *Phillip Morris USA v. Williams*, 127 S.Ct. 1057, 1063 (2007).

Companies would pay damages awards directly to the state, which would distribute the money to citizens in the form of lower taxes, increased benefits, or both. Although each individual case would involve payment after liability was established through some sort of litigation (i.e., “ex post”), over the long run, individuals would be compensated on a regular basis for all of the small loss risks that they would encounter in a given time period.

Doing so would solve three problems that afflict the current system. First, compensation inextricably linked to harm; the only way an individual can currently get compensated is if he gets hurt, even though he faces a range of risks every day. Second, compensation is an uncertainty; the legal system offers aggrieved individuals no guarantee of compensation. When risk aversion is added to the mix, it is clear that individuals are foregoing certain beneficial actions; this skews production and consumption incentives.

The proposed theory also involves far fewer administrative costs than the current system. Under the status quo, if these risks are compensated at all, they are compensated ex post, in proportion to the magnitude of their loss. Class members must be identified, the fund must be administered, and the money must ultimately be distributed to class members. All of these actions involve substantial cost, none of which would arise under the proposed theory.

Finally, regardless of which individuals take the risk of prosecuting a suit, the deterrence and compensation benefits accrue to all members of society. Therefore, there are incentives to free-ride. However, when harm and liability are decoupled as I propose, compensation is a certainty and the free-rider problem is eliminated.

Although this theory can apply broadly, it can have immediate application in the context of undistributed class action funds. When litigation results in undistributed funds, the leftover money should escheat to the state rather than remaining within the equitable discretion of the court. Since almost all such litigation results in undistributed funds, and since all citizens are potential members of the absent plaintiff classes ex ante, directing the money to the state would mean that all citizens will share in the benefit from the award. Under the status quo, distribution occurs unguided by any normative principle and there is no guarantee that the citizenry would benefit from delivering money to an arbitrarily-selected entity.

Conceptually, the theory proposed here is a radical departure from the status quo. However, in its most robust form, it imposes few costs, delivers significant benefits, and yields optimal deterrence.