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Offsetting Benefits

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Offsetting Benefits

Ariel Porat and Eric Posner

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THE UNIVERSITY OF CHICAGO

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OFFSETTING BENEFITS

Ariel Porat* & Eric Posner**

February 13, 2014

There are numerous areas of the law in which the victim of a wrongdoing has the right to obtain damages that compensate her for harm. When the wrongdoing also creates a benefit—either for the same victim or for a third party—a question arises as to whether the damages should be reduced to reflect that benefit. The law is unclear, and courts frequently act inconsistently. We argue that courts should deduct the benefit when it is not offset by another harm to a third party, and would not have existed but for the wrongdoing. We also argue that courts need to take into account the effect of deductions on victims’ and beneficiaries’ incentives to take care, and that measurement difficulties and other complex causal issues provide a basis for denying deductions in many cases.

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INTRODUCTION

In many areas of the law, the victim of a wrongdoing is entitled to damages that compensate her for the harm that she has suffered. This deceptively simple statement of the law hides many complexities. One such complexity involves the treatment of “offsetting benefits”—benefits that the victim or a third party receives as a result of the same act that caused the harm. For the simple two-party case, imagine that the victim is badly injured in an automobile accident but also makes millions of dollars on a memoir that describes her struggle to recover and build a better life. Should the wrongdoer pay damages that compensate the victim for the entire harm, or the harm offset by the benefits (with the possibility that damages could therefore be zero)? For an example of a third-party case, imagine that a wrongdoer causes an accident because he was rushing an injured person to the hospital, or because he swerved to avoid injuring someone else. Should the wrongdoer’s damages be reduced to account for the benefit to the third party?

The legal rules that govern these cases and cases like them are widely acknowledged to be a mess. One example is the rule that courts should offset benefits from harms when the benefits affect the same “interest” as the harms do. Where the perpetrator of a Ponzi scheme periodically makes small payments to a victim but never pays off the principal, it is intuitive that the victim should recover for the net loss. But courts are never clear about how “interest” is defined, and so the rule does not resolve our memoir example. Nor is it clear why it should matter that the same interest is affected by the benefit and the harm. If the purpose of law is to deter harm or ensure that a victim is properly compensated, and the damages are set to the harm without netting out the benefits, then wrongdoers will be overdeterred and victims will be overcompensated.

Adding to the confusion, there are also cases where a wrongdoer hurts a victim while simultaneously benefiting a third party. Here, the law sometimes (1) gives the victim a full recovery against the wrongdoer and the wrongdoer a right of restitution against the third party; (2) gives the victim a full recovery against the wrongdoer and the wrongdoer *no* right of restitution against the third party; or (3) gives the victim only a partial recovery against the wrongdoer, netting out the benefit to the third party

even though the victim does not receive that benefit herself. These inconsistencies appear to arise from conflicts between different principles that animate different areas of the law that overlap in these cases—including tort, restitution, and takings—but when placed side to side, it becomes evident that the overall pattern cannot be justified on normative grounds.

In this paper, we propose some principles to bring order to the law of offsetting benefits. The starting point is to distinguish the social and private effects of a wrongful act. When a single act causes a harm of 100 to the victim but a separate benefit of 80 to the victim, or a benefit of 80 to someone else, then the social cost of the act is only 20. As a general rule, the legal system should ensure that the wrongdoer pays only 20, and not 100—although in the third-party case, this could mean paying 100 to the victim and obtaining restitution of 80 from a third party.

However, as we discuss, a number of further conditions need to be met before a court should offset benefits. Benefits should not be offset when the wrongdoing does not increase the probability that the benefits exist. Such is the case, for example, when an accident that prevents the victim from being on an airplane that crashes is of the same type as an accident that would cause a victim to miss an airplane that does not crash and instead take an airplane that crashes. Benefits should also not usually be offset when doing so would cause the victim or (in the third-party case) beneficiary to neglect precautions. We also explore how difficulties of measuring losses and benefits may justify damages that do not net out benefits. A theme throughout is that there is an asymmetry between restitution law (which typically does not allow benefactors to obtain restitution when benefits they provide are gratuitous) and tort law (where such benefits often may be deducted from a loss if a loss is proven), and this may play havoc with people's incentives. We find that, as a general proposition, courts are justifiably reluctant to offset benefits, but there are many cases in which they should offset benefits when they do not.

In Part I, we discuss two-party cases, where a wrongdoer both harms and benefits a victim and third parties are not affected. In Part II, we discuss three-party cases, where a wrongdoer harms a victim and in the process benefits a third party. Three-party cases are more complex because there are more ways to allocate losses and benefits, but the underlying principles are the same as those that apply to two-party cases. We conclude by summarizing our recommendations for changes in the law of offsetting benefits.

I. TWO-PARTY CASES

There are various situations where a wrongful act results in distinct harms and benefits to the victim, and the question arises as to whether to deduct the benefits from harms and impose liability accordingly. Sometimes the benefit is that the wrongdoing saved the victim from

another injury. In other cases, the benefit is an increase in the victim's welfare, which can relate to the same interest or to a different interest adversely affected by the wrongdoing. In yet other cases, the benefit is created by reparation of the harm: after the harm is repaired the victim is left in a better position than the position she would have been in if she had not been wronged.

In Section A, we present the law's approach to offsetting benefits, according to five categories of cases, with some overlap among them, built upon the variables mentioned above. In Section B, we develop our theory of offsetting benefits and apply it to the case law.

A. *Prevailing Law*

The following example illustrates the first category of cases which we call *saving from another injury*. In those cases, the wrongdoing saved the victim from an injury which could be either more or less severe than the actual injury inflicted upon him by the wrongdoer.

Example 1. Air Crash. While driving his car, the defendant, negligently, hits the plaintiff, who was on her way to the airport to catch a flight, causing a minor injury to her leg. As a result of the accident the plaintiff missed her flight, which later crashed. Should the defendant be liable to the plaintiff for the harm done to her leg?

There is common agreement among legal writers that the benefit of saving the plaintiff's life does not and should not count, and that the defendant should be held liable for the injury to the plaintiff's leg. It is less clear though, *why* that benefit should not count. Some writers argue that there is no causal relationship between the wrong and the benefit,¹ while others maintain that ignoring the benefit is "intuitive."² Another example which illustrates the first category of cases is of a doctor who failed to receive the patient's informed consent prior to the operation that saved her life but also left her with certain injuries. Assume that if the patient had been fully informed she would have refused to undergo the operation. Should the doctor bear any liability towards the patient for the injuries? Courts do not resolve such cases consistently: while some courts impose

¹ Leo Katz, *What to Compensate? Some Surprisingly Unappreciated Reasons Why the Problem Is So Hard*, 40 SAN DIEGO L. REV. 1345, 1353 (2003). See also RESTATEMENT OF THE LAW, SECOND, TORTS § 920, cmt. d (1979), and Illustration 8, *id.*: "A knocks B down, as a result of which B is prevented from taking a ship that later sinks with all on board. B's damages for the battery are not diminished by his escape from death resulting from A's act...".

² See John C.P. Goldberg, *Rethinking Injury and Proximate Cause*, 40 SAN DIEGO L. REV. 1315, 1333 (2003).

liability,³ other courts refuse to do so.⁴

In a second category of cases, *harm and benefit to the same interest*, the benefit which comes along with the injury relates to the same interest harmed by the wrongdoing. The question which then arises is whether the benefit should be deducted from the harm. The general answer is yes: "The damages allowable for an interference with a particular interest [must] be diminished by the amount to which the same interest has been benefited by the defendant's tortious conduct."⁵ Thus, if a plaintiff, a victim of defamation, suffers lost income, but because of publicity earned large

³ See *Warren v. Schecter*, 57 Cal. App. 4th 1189 (defendant failed to disclose to the plaintiff some of the risks of a gastric surgery. Although the surgery cured the plaintiff's stomach ulcer, it caused her a bone disease. The court held that by not revealing to the plaintiff all risks of the surgery, the defendant didn't receive her informed consent, and therefore she is entitled to compensation for all damages proximately resulting from the surgery).

⁴ See RESTATEMENT OF THE LAW, SECOND, TORTS § 920, Illustration 2 (1979): "A surgeon, without B's consent, operates upon B's eye, causing B to lose the sight in that eye. In an action of battery, it may be shown in mitigation of damages for the loss of the eye that had A not operated, the sight of the other eye would have been lost"; Illustration 1, *id.*: "A, a surgeon, having been directed to examine but not to operate upon B's ear, performs an operation that is painful but that averts future pain and suffering. The diminution in future pain is a factor to be considered in determining the amount of damages for the pain caused by the operation." This latter illustration is based on *Maben v. Rankin*, 358 P.2d 681, 684 (1961). See also DAN B. DOBBS, *LAW OF REMEDIES: DAMAGES, EQUITY, RESTITUTION* 489 (Practitioner Treatise ed. 1993) ("[w]hen the tort itself causes both harm and benefits, as in the case of technical battery by a surgeon whose operation, though wrongful, also alleviates the plaintiff's medical condition, a credit is given the defendant for either kind of benefit."); John Marks, *Symmetrical Use of Universal Damages Principles Such as the Principles Underlying the Doctrine of Proximate Cause to Distinguish Breach-Induced Benefits that Offset Liability from those that Do Not*, 55 WAYNE L. REV. 1387, 1412 (2009) ("Under this 'same interest' rule, for example, a plaintiff's recovery of damages for 'pain and suffering' caused by an unauthorized surgical procedure could be offset by 'averted future suffering' also caused by the surgery."). For other cases where courts seem to consider the benefits of the unauthorized medical treatment, see *Stewart-Graves v. Vaughn*, 170 P.3d 1151 (2007) (The patient, a newborn infant, was born without a heartbeat. The physician carried out twenty four minutes of resuscitative medical treatment on the infant without the parents' informed consent; the treatment saved the infant's life, but left him with severe and permanent disabilities. The court determined that the physician was not negligent for failing to withhold resuscitative medical treatment and that the physician had no duty to obtain the parents' consent before resuscitating); *Shinn v. St. James Mercy Hosp.*, 675 F. Supp. 94 (W.D.N.Y. 1987) *aff'd*, 847 F.2d 836 (2d Cir. 1988) (The patient was administered Dilantin to treat his life-threatening seizure activity. The patient was not aware that Dilantin could produce Stevens-Johnson Syndrome and would not have taken the medication had he known this. He later developed Stevens-Johnson Syndrome and brought the case against his physicians. The court determined that the physicians were not liable).

⁵ RESTATEMENT OF THE LAW, SECOND, TORTS § 920, cmt. a (1979). According to § 920, "[w]hen the defendant's tortious conduct has caused harm to the plaintiff or to his property and in so doing has conferred a special benefit to the interest of the plaintiff that was harmed, the value of the benefit conferred is considered in mitigation of damages, to the extent that this is equitable." See *Guenther v. Novartis Pharm. Corp.*, 2013 U.S. Dist. LEXIS 116369, 8 (Plaintiff took a drug to reduce the incidence of pathological fractures occurring in the bones as a result of her cancer, which resulted in harm to her jaw and teeth; she brought a suit for lack of adequate warning; the court was willing to allow an offset for the positive effect of the drug on plaintiff's medical condition).

lectures fees, those fees should be deducted from damages.⁶ But this is not always the case. Consider the following example.

Example 2: Remarriage. In a wrongful death case the plaintiff, the surviving widow, who sues for dependency losses, remarried. Should the benefits from remarriage, emotional or pecuniary or both, be taken into account by the court when it awards damages to the plaintiff for her dependency losses?

In Example 2, the benefit of remarriage is the part of the new spouse's income which supports the plaintiff, and that benefit relates to the same interest harmed by the wrongdoing (the stream of income which came to the plaintiff from the deceased). Therefore, one should expect that offset would be allowed. In fact, however, courts are split on that issue: some courts allow offset⁷ but most courts disallow it.⁸ In other cases the widow has not remarried but there is a chance of remarriage, and the question arises as to whether the likelihood of remarriage should be taken into account by the court in awarding damages. The arguments that are raised against offset are that any estimate of the benefits of remarriage is speculative, that the cause of action arises at the time of the injury before remarriage took place and therefore the benefits of remarriage should be

⁶ RESTATEMENT OF THE LAW, SECOND, TORTS § 920, Illustration 5 (1979): "A charges B with being a member of a secret order. B brings an action for defamation alleging as special damage the loss of income by B as a surgeon. A can show in mitigation of damages that because of the false charge, B has been enabled to attract crowds to lectures given by him, to his great profit". The informed consent cases discussed in *supra* note 4 and accompanying text, can also be analyzed under the second category of cases. See in particular the RESTATEMENT OF THE LAW, SECOND, TORTS § 920, Illustration 1, *supra* note 4 (illustrating the second category of cases by using an informed consent example); DOBBS, *supra* note 4, *id* (same).

⁷ See *Jensen v. Heritage Mut. Ins. Co.*, 127 N.W.2d 228, 234 (1964) (Plaintiff's husband died in a road accident. Six months later she remarried. The court held that the jury should be permitted to consider this fact in assessing the damages). See also *Sipes v. Michigan Central Railroad Co.*, 204 N.W. 84, 85 (1925) (The plaintiff's husband died in an accident while working for a railroad company. The court held that in measuring the damages, the possibility of the widow, who was only 21, to get married should be considered).

⁸ The paradigmatic case is represented in *Coleman v. Moore*, 108 F. Supp. 425, 427 (D.D.C. 1952) (Plaintiff's wife was killed in a road accident. Two years later, he remarried. The court decided that the plaintiff's remarriage shouldn't be taken into account, because "it is an event subsequent to the death when the right to recover damages vested finally and absolutely."). In a similar case, *Bunda v. Hardwick*, 138 N.W.2d 305, 308 (1965), the court refused to permit the defendant to introduce a birth certificate of the plaintiff's child, that was born after her husband's death, from which the jury might have inferred that she had remarried. In an English case, *Thompson v. Price* [1973] Q.B. 838, where plaintiff's husband was also killed in a road accident, the court held that the widow's remarriage should not be taken into account when assessing damages. However, it is a relevant consideration when assessing the damages payable to their mutual child.

ignored,⁹ and that offsetting those benefits, which were forced upon the plaintiff, is inequitable.¹⁰ Counterarguments, raised by courts and commentators, are that measurement problems are not good enough reasons for disallowing offset, and that events occurring after the victim's death count, and should count in measuring damages.¹¹

In a third category of cases, *harm and benefit to a different interest*, the benefit that accompanies the injury relates to a different interest from the one harmed by the wrongdoing. Here, the general rule is, that "[d]amages resulting from an invasion of one interest are not diminished by showing that another interest has been benefited."¹² The application of this rule by courts is often inconsistent. For example, in wrongful birth cases, a question arises as to whether the non-pecuniary benefits of raising the undesired child should be deducted from damages for the monetary costs incurred by the parents in raising him. Although the benefits and harms relate to different interests of the plaintiff, most courts allow deduction, while only a minority of them disallows it.¹³ In other cases, involving

⁹ See Alexander H. Lindsay Jr., *Damages for Wrongful Death and the Possibility of Remarriage*, 32 U. PITT. L. REV. 119, 119-121 (1970-1971) (explaining why courts are reluctant to offset the benefits of remarriage).

¹⁰ Marks, *supra* note 4, at 1414 ("The torts Restatement's open-ended qualification takes into account the extent to which a tort-induced benefit is thrust upon the plaintiff 'against his will'. A poignant illustration is the widowed spouse who remarries and thus enjoys the 'benefits' of a new spouse after the defendant has tortiously killed the prior spouse. To be sure, the new spouse may well provide the same sort of companionship and income-stream that the deceased one did, but is it 'equitable' to give a credit to the defendant who imposed these benefits by tortiously killing the plaintiff's prior spouse?").

¹¹ See *Papizzo v. Robertson Transport, Ltd.*, 401 F.Supp. 540, 542 (E.D. Mich. 1975) ("Jurors can be trusted to give [the evidence of remarriage] its proper weight without allowing it to mislead or unfairly prejudice them"); Francis E. Shields & James T. Giles, *Remarriage and the Collateral Source Rule*, 36 INS. COUNSEL J. 354 (1969) ("...the fact that there may be some uncertainty in measuring damages should not preclude evidence of the marital status of the surviving spouse, because even greater speculation is involved if the true situation is withheld from the jury ... although the right to wrongful death damages may vest at the time of death, facts relating to those damages extend beyond that date and, to refuse to go beyond it, ignores the realities of the situation"); Peter C. Kober, *The Case of the "Wife after Death": Reflections on the Admissibility of Evidence of Remarriage under the Massachusetts Wrongful Death Statute*, 15 NEW ENG. L. REV. 227, 241 (1979-1980) (arguing that ignoring remarriage brings into excessive compensation).

¹² RESTATEMENT OF THE LAW, SECOND, TORTS § 920, cmt. b (1979). See Illustration 4. *id.*: "A charges B with murder. In an action for defamation in which B claims no special damages, the defendant cannot show in mitigation that the business of B, a seller of soft drinks, has been increased as the result of the charge"; DAN B. DOBBS, PAUL HAYDEN, & ELLEN BUBLICK, *DOBBS' LAW OF TORTS*, 2D 489 (Practitioner Treatise Series, 2011) (same).

¹³ See *e.g.*, *Custodio v. Bauer*, 251 Cal. App. 2d 303 (1967) (disallowing offset); *Bowman v. Davis*, 356 N.E.2d 496 (1976) (same); *University of Ariz. Health Sciences Ctr. v. Superior Court*, 667 P.2d 1294 (1983) (allowing offset); *Stills v. Gratton*, 55 Cal. App. 3d 698, 708-09 (1976) (same). See also DAN B. DOBBS, *LAW OF REMEDIES* 666-668 (2nd ed., 1993) ("some courts use the offset under the rule that presumes the parents' emotional benefits to be in excess of all child-rearing costs, the effect being to say that the cost of rearing the child cannot be recovered in wrongful pregnancy cases. But the presumed blessing is not usually presumed to outweigh the costs of pregnancy and delivery, emotional and mental distress and consortium interests... In this category of cases, an additional

trespass on the land that resulted in property damages, the no-offset rule is consistently applied. Thus, a defendant who committed a trespass on the plaintiff's land by flooding it was not allowed to offset the profits made by the plaintiff from selling ice that he cut from frozen spillage on his land, which he could not have done had his land not been flooded.¹⁴ The reason given by courts for not allowing offset when the benefits and harms are not to the same interest is that the benefit was forced on the victim by the wrongdoer, and therefore should not count.¹⁵ Others explain that benefits to a different interest from the one harmed do not meet the proximate cause requirements.¹⁶

The rule against offsetting benefits that relate to a different interest from the harm, has an exception in the Restatement: if the benefit and harm are both economic in nature, offset should be allowed.¹⁷ The extent of this

question arises. Should the emotional benefits of unwanted parenthood be offset only against the parents' emotional distress claims? Or should the emotional benefits be offset against the economic losses of the parents' as well? Decisions in this category have usually concluded that the economic losses and the emotional harm were 'inextricably related to each other'. And that the trier should be allowed to offset emotional benefits against both emotional distress and economic costs... The effect of the offset in this situation is to credit the defendant with benefits to the plaintiff in one category against losses in another. This seemingly violates the normal rules that benefits from a tort are to be offset only against losses to the same 'interests'.")

¹⁴ *Read v. Webster*, 113 A. 814, 818 (1921). But the distinction between harm and benefit to the same or to different interests in trespass cases might be hard to make. *See, e.g.*, RESTATEMENT OF THE LAW, SECOND, TORTS § 920, Illustration 3 (1979): "A tortiously digs a channel through B's land, thereby making it impossible to grow crops upon the land through which the channel runs. It may be shown in mitigation that the digging of the channel drains the remainder of B's land, making it more valuable"; *Burtraw v. Clark*, 61 N.W. 552, 553 (1894) (Defendants admitted that the digging of ditch pursuant to void drain proceedings was a trespass. The court accepted defendants' argument, in which the ditch was a benefit to the owner's property and, thus, her damages should be nominal).

¹⁵ RESTATEMENT OF THE LAW, SECOND, TORTS § 920, cmt. f (1979): "The rule stated in this Section is limited by the general principle underlying the assessment of damages in tort cases, which is that an injured person is entitled to be placed as nearly as possible in the position he would have occupied had it not been for the plaintiff's tort. This principle is intended primarily to restrict the injured person's recovery to the harm that he actually incurred and not to permit the tortfeasor to force a benefit on him against his will."). *See also* DOBBS, *supra* note 13, at 667 ("[I]f the defendant negligently burns down your trees, reducing the value of your land, he does not get any credit for the pleasures you might get because your view is enhanced at the same time your shade is lost. Although those pleasures might be real, they not diminish the economic loss.").

¹⁶ Marks, *supra* note 4, at 1412 ("Recall that under the proximate-cause rubric, liability generally is confined to those losses risked that made the defendant's conduct tortious to begin with. Essentially, the torts Restatement's same interest rule focuses exclusively on the specific range of compensable interests jeopardized by the defendant's tortious conduct, and it symmetrically confines liability offsets to benefits accruing to precisely the same interests (to the extent that those interests were actually harmed by the defendant's tortious conduct).")

¹⁷ RESTATEMENT OF THE LAW, SECOND, TORTS § 920, Illustration 5 (1979): "A charges B with being a member of a secret order. B brings an action for defamation alleging as special damage the loss of income by B as a surgeon. A can show in mitigation of damages that because of the false charge, B has been enabled to attract crowds to lectures given by him, to his great profit."

exception, however, is unclear. Consider the following example:

Example 3: Changing Career. Plaintiff changed his career as a result of a wrongdoing that injured him, and now he earns more than what he would have earned if he had not been wronged. Should the extra earnings he gained as a result of the wrong be deducted from damages for medical expenses or pain and suffering?

While courts would not deduct the extra earnings from damages for pain and suffering (since the harms are not economic),¹⁸ it is less clear whether deduction should be allowed from damages for medical expenses.

In the fourth category of cases, *the reparation benefit*, the benefit to the plaintiff is not the result of the wrong, but of the reparation of the harm. Example 4 illustrates such cases.

Example 4. The Car. The defendant negligently hits and damages the plaintiff's car. In order to repair the car, the plaintiff needs to replace the parts that were damaged. The replacements, however, are new parts since used parts are not available. As a result, after reparation, the value of the car, with the new parts, is higher than its value prior to the accident. Should that added value be deducted from damages awarded for costs of reparation?

Courts reach conflicting decisions, and there is no general rule.¹⁹

¹⁸ Cf. RESTATEMENT OF THE LAW, SECOND, TORTS § 920, Illustration 6 (1979): "A tortiously imprisons B for two weeks. In an action brought by B for false imprisonment in which damages are claimed for pain, humiliation and physical harm, A is not entitled to mitigate damages by showing that at the end of the imprisonment B obtained large sums from newspapers for writing an account of the imprisonment." See *Bochar v. J. B. Martin Motors, Inc.*, 374 Pa. 240, 244 (1953) (plaintiff suffered an injury in his leg as a result of a road accident with the defendant's car. Before the accident he worked for a Telephone Company for 16 years, doing installation, repair and other types of work. After the accident he was assigned to a desk job and earns higher salary. The court held that "a tortfeasor is not entitled to a reduction in his financial responsibility because, through fortuitous circumstances or unusual application on the part of the injured person, the wages of the injured person following the accident are as high or even higher than they were prior to the accident... Where permanent injury is involved, the whole span of life must be considered.").

¹⁹ Some courts have determined that the added value be deducted from damages awarded for costs of reparation. See *Matter of Crounse Corp.*, 956 F. Supp. 1377, 1381-82 (W.D. Tenn. 1996) ("If the Court determines that repair or replacement adds new value to or extends the useful life of property, then an appropriate reduction from the full repair or replacement costs should be made."); see also *Pillsbury Co. v. Midland Enterprises, Inc.*, 715 F. Supp. 738, 764 (E.D. La. 1989) aff'd and remanded, 904 F.2d 317 (5th Cir. 1990) (same). Yet other courts have found that the added value should not be deducted from damages awarded for costs of reparation. See *J.W. Paxson Co., v. Board of Chosen Freeholders*, 201 F. 656 (3rd Cir. 1912) (holding that a reduction in damages for injuries caused by the defendant's negligence is not equitable when the plaintiff was compelled to

In the fifth and last category of cases, “*third party discretionary benefit*,” a third party conferred a benefit upon the plaintiff following the injury and the question arises as to whether that benefit should be deducted from damages. The next example is illustrative of such cases.

Example 5. The Donation. Defendant negligently caused a fire, which destroyed a synagogue. As a result, twenty million dollars were donated to the congregation in order to facilitate the restoration of the synagogue. Should the donations be deducted from damages and reduce defendant’s liability accordingly?

Example 5 is based on a real case, which was eventually settled out of court.²⁰ The general rule under the common law is that collateral source benefits – namely, payments made by third parties to the plaintiff following the injury – should not be offset from damages.²¹ That rule applies mostly to cases where the plaintiff paid for the right to receive the benefits before the injury took place. The typical example is payments made by insurers either to the victim or, in case of death, to her survivors. In such cases, it is settled law that the injurer should not benefit from the insurance purchased by the victim and therefore offset should not be allowed.²² Indeed, in some cases the insurer has a right of subrogation against the wrongdoer,²³ and then an offset from plaintiff’s damages is allowed, in order to avoid double

replace the damaged property prematurely); *see also* United States v. Ebinger, 386 F.2d 557, 561 (2d Cir. 1967) (“[I]t has been generally held that the defendant is not entitled to a credit merely because the plaintiff has acquired a new unit, presumably with a longer life expectancy than the old, if that was the cheapest course available.”). *See also* DOBBS, *supra* note 13, at 556 (clarifying that the general rule is that the defendant’s liability for reparation’s expenses should be reduced by the enhancement of the plaintiff’s property’s value, but if the increase in value isn’t desired by the plaintiff, the enhancement in the property’s value would not be deducted from damages).

²⁰ *See* Diana B. Henriques & Leslie Eaton, *Once and Future Issue: Subtracting Donations From Damage Awards*, N.Y. Times, November 18, 2001 (The defendant, Turner Construction Company, was found partially liable for the fire that nearly destroyed the Central Synagogue on East 55th Street. One of the defendant’s arguments was that the amount of compensation should be deducted as a result of the \$20 million donors had given the synagogue, which help it’s rebuilding).

²¹ *Cary v. Burris*, 127 P.2d 126, 128 (1942) (“Damages cannot be reduced by an amount which the plaintiff may have received from third parties, acting independently of the defendant, though it is given to the plaintiff on account of the injury.”).

²² *See* RESTATEMENT OF THE LAW, SECOND, TORTS § 925 cmt. h (1979): “The fact that one or more of the beneficiaries receives insurance payable on the death of the deceased or inherits property from the deceased does not diminish the damages recoverable.”; *Tebo v. Havlik*, 343 N.W.2d 181 (1984) (Plaintiffs in two cases alleged injuries resulting from automobile collisions caused by defendants. The court held that “[t]he collateral-source rule provides that the recovery of damages from a tortfeasor is not reduced by the plaintiff’s receipt of money in compensation for his injuries from other sources.”)

²³ Such is always the case with property damages, but often also with bodily injury. *See* DOBBS, *supra* note 13, at 268 (“One of the reason commonly given in support of the collateral source rule is that the rule preserves subrogation rights of any insurer who paid benefits to the plaintiff.”).

charging the defendant for the same harm.

Things are more complicated when benefits have not been purchased before the injury, or have not been purchased at all, as in example 5. Should those benefits be deducted from damages? The general rule is that benefits conferred on the victim from third parties, at their discretion, should not be offset against damages, since the third party aimed to benefit the victim, not the wrongdoer.²⁴ Furthermore, any such offset would constitute a windfall for the defendant, which he does not deserve.²⁵ Typical examples belonging to this category of cases are medical services, or other assistance, that the victim received from her family or friends at no cost for herself,²⁶ salary paid by her employer when she was unable to work as a result of the injury, and donations paid to her by charities or other benefactors.²⁷

B. Theory

In this section we develop our theory and apply it to the case law. Courts should calculate damages by subtracting benefits from the loss

²⁴ See RESTATEMENT OF THE LAW, SECOND, TORTS § 925 cmt. h (1979): "Likewise the fact that support, education or other gratuities have been received from third persons, although induced by the death, or that the survivors will be cared for by third persons, does not mitigate the damages".

²⁵ See DOBBS, *supra* note 13, at 268 ("When the collateral benefit comes in the form of a gratuity from friends or employers, courts sometimes say that the donor intends to benefit the plaintiff, not the defendant, and that therefore the defendant should have no credit for the benefit."). See also *Nashville, C. & S. L. Ry. v. Miller*, 47 S.E. 959 (1904) (The victim was injured in a railroad collision, and the trial court found that he was entitled to damages from a railway company involved in that accident. The court concluded that "[w]here an employer pays to an injured employee, as a matter of grace, the amount which he would have earned as wages if he had not been disabled, a wrong-doer has no concern with this transaction between the employer and the employee, and the amount so paid is not to be regarded as in any sense compensation for lost time."). For criticism of this approach see DOBBS, *id.*, at 268 ("[I]t is hard to say the defendant gets a windfall if the plaintiff is fully compensated or if his injury is less by luck than one might expect from the defendant's tort.").

²⁶ See *Coyne v. Campbell*, 183 N.E.2d 891 (1962) (The plaintiff, a doctor, received medical services from his colleagues at no cost, and offset was not allowed. The court reasoned that "a wrongdoer, responsible for injuring the plaintiff, should not receive a windfall. Were it not for the fortuitous circumstance that the plaintiff was a doctor, he would have been billed for the medical services and the defendant would have had to pay for them. The medical services were supplied to help the plaintiff, not to relieve the defendant from any part of his liability or to benefit him."). See also *Oddo v. Cardi*, 218 A.2d 373, 377 (1966) (disallowing the offset of the benefits of gratuitous medical services); *Hudson v. Lazarus*, 217 F.2d 344, 346 (1954) (same).

²⁷ See *Redpath v Belfast*, [1947] NI 167, where after a train accident the local community established a charity fund for compensating the victims. The court disallowed offsetting the payments made by the fund to the victims: "The possibility of such a fund being formed is a contingency altogether too remote to enter into the calculation and assessment of damages. The creation of the fund was a circumstance of a wholly, independent or collateral character to the defendants' negligence; and from it there could at the time of the accident have been no reasonable expectation of pecuniary benefit." *Id.*, at 175.

when those benefits are social rather than private. Benefits are social rather than private when they are themselves not canceled out by a loss to a third person. We further argue that benefits should be deducted only when their likelihood of realization is increased by the wrongdoing. We explore how those principles should be applied by courts, taking account of various second-order problems, like measurement difficulties and incentives of victims, that may justify exceptions to the general principle.

1. Social vs. Private Benefits

At the heart of our theory is the distinction between private and social benefits: damages should equal the social, not private loss, caused by a wrongdoing. This means that damages should equal the victim's loss minus any benefit, so long as that benefit is social. A benefit is private but not social, when it is offset by an equivalent harm to a third party; if the wrongdoer is not liable to the third party for the harm she suffered, but the benefit to the plaintiff is deducted from damages, the wrongdoer is liable for less than the social harm he created, and is under-deterred. To illustrate, suppose that in Example 1 (the Air Crash), while the plaintiff missed her flight and was saved from an air crash, a third party who was assigned the plaintiff's seat on the plane, was killed. The plaintiff gained a huge benefit from the wrongdoing, but the third party suffered an equivalent harm. Under those circumstances, exonerating the defendant from liability is unjustified.

The social/private distinction could provide a new explanation for courts' reluctance to deduct the benefits of remarriage from damages to the dependent widow (Example 2). The loss of income to the widow represents part of the loss of the deceased's life. That latter loss, which is social, has not been mitigated by remarriage. The pecuniary benefits the widow received is just a transfer of wealth from the new spouse to her, which but for the wrongdoing would have been transferred to another person, or remained with the new spouse. Therefore, the widow's damages should not be offset by the benefit. By contrast, consider the non-pecuniary loss of consortium. Here, remarriage has mitigated that loss, and the widow's damages should be reduced: the affection the widow received from the new spouse is not a "transfer of affection" from another person,²⁸ or an "asset" that would have remained with the new spouse but for the wrong.

The social versus private distinction does not track the legal rule that benefits should be offset only when they relate to the interest that is harmed.²⁹ We therefore believe that this rule cannot be sustained. The

²⁸ Theoretically, it might be the case that but for the wrong the affection of the new spouse would have gone to another person; but taking that into account is too speculative: the other person could have received affection even without the new spouse, from yet another person, and so on and so forth.

²⁹ *Supra* text accompanying notes 5-16.

distinction could explain, however, the relevance the law ascribes to the fact that the benefit is the result of a discretionary act of a third party. Consider the donation case (Example 5), where people donate money to reconstruct the destroyed synagogue. At first glance, no deduction should be made, simply because the benefit to the plaintiff is accompanied by an equivalent loss to the donors: money has just switched hands. That, however, is not accurate. The donors derived benefit (in the form of utility, a kind of “warm glow”³⁰) from donating the money; otherwise they would not have donated it in the first place. Therefore, one might argue that the wrongdoing created a benefit to a donor (the opportunity to give and hence to enjoy the satisfaction of giving) as well as a harm to the victim. Note, however, that under this theory the potentially offsetting benefit is not the amount of the money that has been donated, but a smaller amount reflecting the utility of giving. Indeed, a donor might donate \$100 if her gross benefit is \$101, for a net benefit of \$1.³¹

This conclusion is problematic for three reasons. First, many donors would have donated the money—but for the wrongdoing—for other purposes, and derive the same (or almost the same) utility from doing so. Therefore, donating the money for reconstructing the synagogue has been done at the expense of other social goals which would have been promoted but for the wrongdoing. This reason, however, holds only if we assume that the donors would have donated the money anyway, with or without the wrongdoing, and such assumption does not always hold. Second, if the benefits of the donations had been deducted from damages, many donors, knowing that in advance, would not have donated the money in the first place, because the only effect of their donation would be to reduce the liability of a wrongdoer, not to help an institution they care about. Thus, they would not have been able to derive any utility from such donation. Third, practically, it is hard to measure the net benefit of donations, since, as we have explained, the social benefit is not the amount of money donated, but typically a much smaller amount that is intrinsically difficult to measure—the utility or warm glow that people receive from giving.³²

For all those reasons, we think that donations, even if they create social benefits in many cases, should not warrant any deduction from damages.

2. *Ex-Ante Increase of Expected Benefits*

Even when the plaintiff’s benefits are social rather than private, they

³⁰ See James Andreoni, *Impure Altruism and Donations to Public Goods: A Theory of Warm-Glow Giving*, 100 *ECON. J.* 464 (1990) (modeling the motivation for giving as a factor in the donor’s utility function).

³¹ We will discuss three-party cases like this one in more detail in *infra* Part II.

³² *Supra* text following note 30.

should not be deducted from damages if the probability of their creation was not increased, *ex ante*, by the wrongdoing. To illustrate, even if in the air crash example no additional third party was injured as a result of the wrongdoing, deduction should still not take place, since road accidents do not increase the probability that victims of those accidents would be saved from air crashes. Indeed, the probability that a road accident would save a person from air crash—as in Example 1—is equal to the probability that a road accident would cause a person to be killed in an air crash. Thus, in one case a person injured in a road accident would miss a flight which crashes and take a flight which does not crash, and in another case he would miss a flight which does not crash and take a flight which crashes. Tort law does not impose liability on the negligent driver in the latter case for good reasons,³³ and once such liability is not imposed, the benefits of saving the plaintiff's life should not be deducted from damages. Otherwise, the negligent driver would be under-deterred: he would not internalize all the negative effects of his negligence but would internalize its positive effects.

Note, that our argument has nothing to do with foreseeability, which is another condition for tort liability under tort law.³⁴ even if air crashes were very common, so that every driver would have known that missing a flight as a result of road accident could save a person's life, liability should not be imposed. Also note the subtle distinction between the current argument and the social vs. private argument discussed in the previous section: while the latter argument is based upon the premise that some actual benefits are accompanied by actual harms which cancel each other out, the former argument is based upon the premise that even if *in fact* the wrongdoing created a benefit with no correlative harm, the wrongdoing might lack the attribute of increasing the likelihood that the benefit which was actually created, would be created.

The *ex-ante* increase in expected benefits ("EIB") condition, as we will call it, does not support the common legal distinction between cases where the harms and benefits are to the same interest and cases where the harms and benefits are to different interests.³⁵ It also does not support the legal rule which disallows deduction of a third party's discretionary

³³ See RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 29 (2010): "An Actor is not liable for harm when the tortious aspect of the actor's conduct was of a type that does not generally increase the risk of that harm." For the logic of this condition for tort liability, which Guido Calabresi called "causal linkage", see Guido Calabresi, *Concerning Cause and the Law of Torts: An Essay for Harry Kalven, Jr.*, 43 U. CHI. L. REV. 69 (1975).

³⁴ See RICHARD EPSTEIN, TORTS 270 (1999) (arguing that in cases of "freakish events," the bizarre consequences could never have influenced a defendant's primary conduct and, hence, should not generate liability for the defendant, whose negligence is defined with reference to some standard, nonfreakish set of consequences); DAN B. DOBBS, THE LAW OF TORTS 447 (2000) (courts wouldn't award damages if the harm or the plaintiff were unforeseeable, even though the defendant was found negligent).

³⁵ *Supra* text accompanying notes 5-16.

benefits.³⁶ As long as the wrongdoing increased the likelihood that a certain benefit would be created, be it discretionary or not, the EIB is met.

The EIB could justify a non-deduction rule in Example 3 (Changing Career). In this example, the victim changed his career because of the wrongdoing that caused physical injury, and now he earns more than what he would have earned but for the wrongdoing. The question that arises is whether the extra earnings should be deducted from other items of losses, such as medical expenses. It seems that the EIB is not met in Example 3: wrongdoing does not increase the likelihood that victims will change their minds and improve their earning capabilities (or earning opportunities). Although changing of minds as a result of injury might happen from time to time, it might also happen—and even more so—without an injury. So wrongdoing does not have the attribute of increasing the likelihood of people changing their minds and improving their earnings. Furthermore, if a victim decides to change his career because of an injury—not because of his diminished capabilities, but just because of a change of mind which has been triggered by the wrongdoing—and now he earns *much less* than what he would have earned but for the injury, he would not be compensated for the lost earnings which is the result of his change of mind (as opposed to change of capabilities). In the same way, the wrongdoer should not be credited for a change of mind of the victim that makes him earn *much more* than what he would have earned but for the injury. In the next section, we will see that there could be other reasons for not crediting the wrongdoer for the victim's extra earnings, so the EIB is only one possible reason among others for non-deduction.

3. *Victim's Incentives*

In the previous two sub-sections we have discussed two necessary conditions for deducting benefits from damages. In this and the next two sub-sections we discuss considerations—rather than conditions—which should be taken into account in deciding which types of benefits should be deducted from damages.

Deduction could affect the victim's incentives. In particular, when victims can affect the accumulation of the benefits that would later be deducted from their damages, they might underinvest in creating those benefits, change their activity to reduce the magnitude or likelihood of those benefits, or postpone their realization until after trial. Consider Example 2 (Remarriage): if the benefits of remarriage are deducted from the damages, the widow might avoid remarriage before trial just in order to be entitled to higher compensation. Interestingly, the victim's incentives would be differently affected by an offset rule, if in addition to remarriage also the *possibility* of remarriage is taken into account in awarding

³⁶ *Supra* text accompanying notes 24-27.

damages. Under that latter rule, a victim who knows that even if she does not get married her damages would be reduced as a result of the possibility of remarriage, would be less deterred from getting remarried (especially if she believes that the court would consider the likelihood of remarriage as high) than if only actual remarriage had been taken into account. But the rule that the possibility of remarriage—not only actual remarriage—be taken into account in awarding damages also has its flaws. In addition to measurement difficulties—which we discuss in the next section—widows might inefficiently reduce the possibility of remarriage, or at least make efforts to make that possibility hidden, or non-verifiable, until after trial. Therefore, a possible solution to the remarriage example—assuming the main obstacle for allowing deduction of benefits is the distortion of the victim's incentives³⁷—is to allow deduction for the possibility of remarriage at a fixed rate, regardless of the actual possibility of remarriage, and regardless of whether actual remarriage takes place. Under our solution, widows would know that they cannot affect the compensation awarded to them for dependency losses and the distortion of their incentives would be removed.³⁸

Example 3 (Changing Career) and Example 5 (Donations) also raises the issue of the victim's incentives. If deduction of benefits is allowed in Example 3, victims' incentives to change career and earn more will diminish, since some, if not all of their extra earnings will be credited to the wrongdoer. A similar problem arises with Example 5: with deduction of donations from damages, victims would not make efficient efforts to raise donations. At least when donations might increase social welfare,³⁹ a no deduction rule would be preferable.

There might be a tension between the goal of improving the victim's incentives, and the goal of making the injurer pay for no more than the harm caused by his wrongdoing, in order to avoid over-deterrence. When this tension exists, one possible way to attenuate or even remove it is to allow an average, or a fixed rate deduction of benefits, where its magnitude is independent of the actual benefits accrued to the victim.⁴⁰

4. Measurement of Unrequested Benefits

The law treats negative externalities—the harms injurers cause to victims—and positive externalities—the benefits benefactors confer on the recipients of those benefits—in a completely different way. Whereas the

³⁷ *But see supra* Section I.B.1.

³⁸ *Cf.* Robert Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution*, 73 CAL. L. REV.1, 14-15 (1985) (proposing that by incorporating a liquidated damages clause into their contracts, the parties avoid the risk of the promisee's over-reliance on the contract, since the promisee's entitlement to damages does not depend on her actual loss).

³⁹ *Supra* text accompanying notes 30-32.

⁴⁰ *Supra* text accompanying notes 37-38.

law does require that injurers bear the harms they create (or wrongfully create), benefactors are seldom entitled to recover for benefits they voluntarily confer on recipients without the latter's consent. There are various reasons, economic and non-economic alike, for the law's different treatment of negative and positive externalities.⁴¹ One main reason, which is our focus here, is that if benefactors are routinely allowed to create unrequested benefits and to obtain restitution for those benefits, they have an incentive to circumvent the market. For example, a painter might paint someone's house without asking permission and then sue for restitution of the benefit conferred. If a court awards damages—say, equal to the market price—the owner may end up paying for a paint job that she doesn't want. In theory, a court could award damages equal to the actual benefit to the owner—if she would have been willing to pay only \$100 for a paint job whose market price is \$500, she should pay only \$100, not \$500—and then the painter would avoid painting houses unless he has good reason to believe that the owner wants the paint job. In such a world, the law replaces transactions. But no one believes that courts could make proper valuations, and instead they deny restitution so that the painter will instead bargain with the owner, and in that way elicit the owner's true valuation.⁴² Moreover, allowing restitution in such cases would constitute an infringement of the recipient's autonomy.⁴³

These considerations are less convincing when transaction costs are high, and market transactions are therefore infeasible. Indeed, the major exceptions to the rule against liability for unrequested benefits are characterized by the presence of high transaction costs between the parties.⁴⁴ Benefits forced on the victim through wrongdoing, can be

⁴¹ See Ariel Porat, *Private Production of Public Goods: Liability for Unrequested Benefits*, 109 MICH. L. REV. 189 (2009) (referring to the law's differing treatment of negative and positive externalities); see also Giuseppe Dari-Mattiacci, *Negative Liability*, 38 J. LEGAL STUD. 21 (2009) (same); Scott Hershovitz, *Two Models of Tort (and Takings)*, 92 VA. L. REV. 1147 (2006) (same); Saul Levmore, *Explaining Restitution*, 71 VA. L. REV. 65 (1985) (same); Oren Bar-Gill & Lucian Arye Bebchuk, *Consent and Exchange*, 39 J. LEGAL STUD. 375 (2010) (same).

⁴² Porat, *supra* note 41, at 209-10.

⁴³ Porat, *supra* note 41, at 215-17.

⁴⁴ In one type of cases the benefactor conferred the benefits upon the beneficiary under circumstances of emergency when obtaining the beneficiary's prior consent was impossible. See RESTATEMENT OF RESTITUTION AND UNJUST ENRICHMENT, THIRD § 20 (2011): "A person who performs, supplies, or obtains professional services required for the protection of another's life or health is entitled to restitution from the other as necessary to prevent unjust enrichment, if the circumstances justify the decision to intervene without request."; RESTATEMENT OF RESTITUTION AND UNJUST ENRICHMENT, THIRD § 2(3): "There is no liability in restitution for an unrequested benefit voluntarily conferred, unless the circumstances of the transaction justify the claimant's intervention in the absence of contract." See, e.g., *Cotnam v. Wisdom*, 104 S.W. 164 (1907) (a doctor who performed emergency surgery on an unconscious injured passerby was awarded restitutionary damages for his services). In another type of cases a beneficiary of a common fund who acts to increase its value can recover a share of her costs from other beneficiaries, even if they refused to support these efforts on behalf of the common fund. In those cases, by imposing

considered as another exception to the rule against liability for unrequested benefits: in the typical tort case transaction costs between the parties, prior to the infliction of the harm and the creation of the benefit, are prohibitively high, and market transactions are not feasible. Therefore, measuring both the harms and benefits and awarding the victim the difference between the two seem to be both vital and right.

Still, the benefits accrued to the victims have not been requested by her, and measurement problems do often exist. Some commentators believe that as between faulty injurer and innocent victim, errors should be allocated to the former,⁴⁵ which implies that doubts about the existence of a true benefit for the victim as well as about its magnitude, should be resolved in the victim's favor.⁴⁶

From an efficiency perspective, the question is harder. Take the case of wrongful birth, when question arises as to whether to deduct the non-pecuniary benefits of raising the child from the expenses incurred in raising him.⁴⁷ The benefits are very hard to measure, not only because they are intangible, but also because the parents will typically want to avoid inflicting emotional harm on their child by publicly arguing that they obtain no benefit from his existence. It is difficult to know how to resolve such a case. The usual rule is that the plaintiff must prove the loss. If the medical bills are plausibly offset by large non-pecuniary gains, then perhaps the plaintiff should receive only a nominal award.

The measurement problem might arise also with pecuniary losses. Example 2 (Remarriage) involves uncertain benefits. Even if remarriage

liability, restitution law aims at overcoming a free-riding problem that otherwise might arise and prevent efficient transactions between the beneficiaries of the common fund. The RESTATEMENT OF RESTITUTION AND UNJUST ENRICHMENT, THIRD § 20 allows recovery in cases where "the recipient obtains a benefit in money," thereby substantially broadening the common-funds category of cases. For examples of common fund suits brought by an heir against her co-heirs, see the RESTATEMENT OF RESTITUTION AND UNJUST ENRICHMENT, THIRD § 29, illustrations 23-25, and 2 GEORGE E. PALMER, *THE LAW OF RESTITUTION* §§ 6.1, 10.7 (1978).

⁴⁵ See e.g., Stephen R. Perry, *The Moral Foundations of Tort Law*, 77 IOWA L. REV. 449, 468 (1992) (arguing that justice considerations favor the victim over the wrongdoer); Jules L. Coleman, *Mental Abnormality, Personal Responsibility, and Tort Liability*, in MENTAL ILLNESS: LAW AND PUBLIC POLICY 107, 120-21 (Baruch A. Brody & H. Tristram Engelhardt Jr., eds., 1980) (same).

⁴⁶ The "difficulties of measurement" argument is usually used in remarriage cases. See Marks, *supra* note 4, at 1414 ("[C]onsider the case of a wrongful-death plaintiff who remarries, and just imagine the kind of burden presented if the law of damages actually pressures him or her to testify in court to the effect that the new spouse is not nearly as good as the deceased one. Is that 'equitable'?"). For a different approach see Francis E. Shields & James T. Giles, *Remarriage and the Collateral Source Rule*, 36 INS. COUNSEL J. 354, 355 (1969) ("[T]he fact that there may be some uncertainty in measuring damages should not preclude evidence of the marital status of the surviving spouse, because even greater speculation is involved if the true situation is withheld from the jury... although the right to wrongful death damages may vest at the time of death, facts relating to those damages extend beyond that date and, to refuse to go beyond it, ignores the realities of the situation.").

⁴⁷ *Supra* text accompanying note 13.

takes place, it will be difficult to measure the benefit to the widow; and if marriage is just a possibility, the “option value” of marriage would be even harder to value. Even when remarriage takes place, the new marriage will not necessarily last forever. There are too many contingencies which could affect the stability of the new marriage, which are hard to predict. The same problem exists with a *possibility* of remarriage; indeed, the speculative nature of the benefits of the possibility of remarriage is one of the main reasons mentioned by both courts and commentators to completely ignore them. One could question that latter argument: if remarriage, when it lasts, produces benefits, the measurement problem only justifies a cautious offset, instead of no offset at all.⁴⁸

Another case, which at first glance does not raise measurement difficulties, is illustrated by Example 5 (the Car). In that example the victim repaired his car, and after reparation its value exceeds its prior value, before it was damaged by the wrongdoer. Why shouldn't that value be deducted from damages? Some courts allow such deduction, while others do not.⁴⁹ On the one hand, measurement seems to be easy in Example 5: the market value of the car increased, and the added value can be objectively quantified. On the other hand, it is unclear whether the victim would have agreed to pay for the added value of the car if he had been asked about it before the injury. In other words, it is unclear whether the victim *really* received a benefit, and if so at what magnitude. Things become especially complicated when the added value is significant. Suppose that instead of a car, it was a 10 million dollar house that was damaged, and after repair its market value increases to 11 million dollars. The owner might argue that he is not interested in selling the house, and that he hasn't received any intangible benefit equivalent to the amount of one million dollars. If his compensation is reduced by one million dollars, the victim might argue, he would not be able to maintain the house, unless he takes loans that he prefers not to take. The victim would claim, then, that it does not make sense that his life and plans would change because of the wrongdoing, even if, economically speaking, he would be restored to the same position he would have been in if the wrongdoing had not occurred.

In theory, it is easy to determine what the right damages are. In some cases, the victim fully consumes the improvement. A victim might place zero value on a shiny new fender that is functionally identical to the old, or a victim might place a great deal of value. This value that the victim obtains would then provide a benchmark for determining the magnitude of the benefit that is offset. In other cases, the improvement increases the resale value of the asset, in which case the benefit to the victim is that amount reduced to present value. In both cases, a further complexity is that

⁴⁸ *But see supra* Section I.B.1, where we questioned the social benefit nature of remarriage.

⁴⁹ *Supra* note 19 and accompanying text.

the victim might not have been willing to pay for the improvement because of capital constraints—it is hard to borrow. Forcing the victim to pay for the increased value of the new fender forces her to convert a liquid asset (dollars) into an illiquid asset (part of a car). For large amounts of money, this will be a relevant consideration. However, one solution to this problem would be to place a lien for the added value of the house to the wrongdoer's benefit.⁵⁰ In this way, the victim would enjoy the added value but would not be required to pay for it until she sells or otherwise liquidates the item.

In general, one might authorize courts to take into account all these factors when deciding whether, and how much, to credit the wrongdoer for the increase in property value caused by the repair. In practice, simple rebuttable presumptions—either in favor of an offset or against—may be justified.

5. *Interlinking Non-Compensable Harms*

A third and last consideration is that the presence of uncompensated harms of the plaintiff could justify, under certain conditions, no deduction of benefits that otherwise would have been deducted. In particular, there is no sense in deducting a benefit that is derived from, or interlinked with, a harm that is not compensated. Thus, if a person is wrongfully injured and as a result works less and earns less than prior to the injury, he is entitled to compensation for lost earnings, but the benefit of a longer leisure time he enjoys following the injury should not be deducted from damages.⁵¹ A possible reason is that working less because of the injury could cause emotional harms side by side with the benefits of longer leisure time. As

⁵⁰ Cf. RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT § 26 cmt. a (2011) (“if the claimant has made expenditures to protect an interest in common property that potentially exceed the value of the defendant's interest, the basic requirement that a liability in restitution not prejudice an innocent recipient (§ 50(3)) is implicitly observed by giving a remedy by equitable lien or subrogation, rather than by money judgment”); Porat, *supra* note, at 212 (suggesting the lien solution for unrequested benefits); Palmer, *supra* note 44, at § 1.5(a) (explaining how equitable lien is used to protect plaintiff rights); *Graham v. Inlow*, 790 S.W.2d 428, 430 (1990) (“It is well settled that a tenant in common has the right to make improvements on the land without the consent of his cotenants; and, although he has no lien on the land for the value of his improvements, he will be indemnified for them, in a proceeding in equity to partition the land between himself and cotenants, either by having the part upon which the improvements are located allotted to him or by having compensation for them, if thrown into the common mass.”); *In re Mach*, 25 N.W.2d 881 (1947) (discussing an equitable lien in circumstances of performance of another's duty); *Bennett v. Bennett*, 36 So. 452, 453 (1904) (holding that a tenant in common is entitled to a lien on the shares of his cotenants in the land for taxes paid by him beyond his proportionate share and for any sum due him for improvements or rent from his cotenants).

⁵¹ See Katz, *supra* note 1, at 1353. Katz presents an example of a professional athlete, who lost her legs as a result of the defendant's tortious conduct. As a result of the defendant's act she is much happier since she can redirect her life into a route from which she ends up deriving greater benefit.

long as the former is not compensated, the latter should not be deducted from damages.

Consider the example of the wrongful birth cases:⁵² the benefits to the parents of having the unwanted child—that is the emotional attachment that will usually develop despite the fact that the parents sought to avoid having a child—might be accompanied with sorrow and frustration. Those harms are generally uncompensated; they are emotional harms which are hard to measure. Given that those harms are not compensated, it makes sense not to deduct the benefits of having the child.

Finally, consider again Example 3 (Changing Career). Should the extra earnings be deducted from damages? It might be the case that the victim who changed career following the injury and earns more, has lost something: after all he has not chosen that new career before the injury. For example, imagine that the victim enjoys the outdoors, and can no longer perform his job as a forest ranger as a result of the injury, and would not enjoy the indoor clerical job that is available. In principle, the court could deduct the extra earnings and award damages for the forgone enjoyment, but measuring forgone enjoyment may be difficult. The courts could address this problem instead by refusing to deduct the benefit (the extra earnings) and also refusing to award damages for the forgone enjoyment. This might suggest that the victim does not derive as much enjoyment from the new career as he did from the old career, in which case his greater earnings does not mean he is necessarily better off with his new occupation. Crediting the injurer for the extra earnings without charging him for the intangible losses that the victim probably suffers does not make sense.

6. Summary

Our starting point is that liability should be imposed for the net social harm. Therefore, there should be two necessary conditions for offsetting benefits from harm: (1) the benefits are social rather than private (meaning that they are not offset by harms to others); (2) the wrongdoing increased, from an ex ante perspective, the probability that those benefits would be created. If those two conditions are met, the following questions should be answered by courts before allowing offsetting of benefits: (1) Would an offset adversely affect victim's ex ante incentives? (2) Would it be too difficult to measure the benefits? (3) Are there uncompensated harms that interlink with the benefits? If the answers to all three questions are negative, offset should be made.

If instead some or all answers are positive, then courts must make a complex, all-things-considered decision. The table below summarizes the examples discussed in Part II, along the two necessary conditions, and the

⁵² *Supra* text accompanying note 13.

three considerations, for offsetting benefits discussed above. As the table shows, the case for offsetting benefits is rarely very strong, and this may explain courts' reluctance to offset benefits in many settings.

Table 1: Summary of the Two-Party Analysis

	Social Benefit?	Ex-Ante Increase?	Victim's incentives problem?	Measurement Problems?	Interlinking Harms?
Air Crash	sometimes	no	no	no	no
Remarriage	maybe no	yes	yes	yes	no
Changing Career	yes	no	yes	no	yes
Car	yes	yes	no	sometimes	no
Donations	sometimes	yes	sometimes	no	no
Wrongful Birth	yes	yes	no	yes	yes

II. THREE-PARTY CASES

In many cases, a wrongdoer harms a victim but in the process also benefits a third party. Thus, the social cost of the act is, as a first approximation, the harm minus the benefit. Typically, the law does not offset benefits in these cases, with the result that the wrongdoer must pay full compensation to the victim, and the damages are greater than the social loss. In some cases, however, the law reduces the liability of the wrongdoer—either by directly reducing damages by the benefit, or by giving the wrongdoer a restitution right against a beneficiary.

A. Prevailing Law

The victim of a tort may sue the wrongdoer for damages that compensate the victim for the loss caused by the tort. As we saw in Part I, in some cases the victim's damages may be offset if the wrongdoer confers benefits on her. However, the law is much less likely to reduce the damages by the value of any benefits conferred on third parties.

Example 6. Injured Passenger. The passenger in a car has a heart attack and the driver rushes her to the hospital, hitting a pedestrian

along the way. The driver saves the life of the passenger but badly injures the pedestrian.

No legal rule permits the driver to deduct from the damages that he must pay to the pedestrian the benefit that he confers to the passenger.

It is easy to think of numerous other everyday settings where an act harms one person but benefits another, and the law does not calculate damages by subtracting the benefits from the loss. An employer exposes workers to a toxin but gives free health screenings that allow doctors to catch unrelated diseases at an early stage.⁵³ The employer might argue that even if it must pay damages to workers harmed by the toxins, it should receive a credit for workers whose lives are saved by the early detection of the diseases which are unrelated to the toxins. A pharmaceutical company manufactures a drug that produces unanticipated negative side effects for one group of customers but unanticipated positive side effects for another group. If the injured customers sue the pharmaceutical company for damages, it is most unlikely that the damages would be reduced to reflect the benefit to the other group.

One might argue that if the defendant is entitled to credit for benefits, then the victims will be undercompensated. But this is not the case if the defendant can obtain restitution from the beneficiaries. As we will see, restitution is available in some related cases, but not in the Injured Passenger or other examples.

Let us now consider some exceptions to the rule that defendants receive no credit or deduction for benefits conferred on third parties. The first exception is only a quasi-exception. A number of doctrines permit a defendant to avoid *liability* (rather than pay reduced damages) when the defendant injures or kills someone in order to protect a third party who is being threatened by the victim.⁵⁴

Example 7. Defense of another. Robber threatens to inflict harm on Victim unless Victim hands over her wallet. Third Party tackles Robber, causing an injury to Robber of \$100; Victim's wallet contains only \$20.

⁵³ Such is the case of firefighters. The National Fire Protection Association (NFPA), a leading organization intended to protect firefighters' safety, recommends that all fire departments establish occupational medical evaluation programs (*See* NATIONAL FIRE PROTECTION ASSOCIATION, NFPA 1582: STANDARD ON COMPREHENSIVE OCCUPATIONAL MEDICAL PROGRAM FOR FIRE DEPARTMENTS §§ 7 (2013)). The recommendation is based on the increase in occurrences of cardiac diseases among firefighters. Although the examination's aim is to detect work-related medical problems, it will also discover unrelated problems that interfere with the firefighter's physical ability (*id.*, § 7.2.2).

⁵⁴ RESTATEMENT OF THE LAW, SECOND, TORTS § 76 (1979) (The actor is privileged to defend a third person from a harmful or offensive contact or other invasion of his interests of personality under the same conditions and by the same means as those under and by which he is privileged to defend himself).

If Robber sues Third Party in tort, Third Party may avoid liability by showing that he acted reasonably to protect Victim. But if the court finds that Third Party acted unreasonably, then the damages will not reflect the offsetting benefit—so the damages will be \$100 rather than \$80. There is a discontinuity here: third-party effects are relevant until a certain point—for the purpose of determining liability. Once we reach that point (negligence is found), third-party effects are completely ignored.⁵⁵

Our second exception is the economic loss doctrine, which provides that plaintiffs cannot recover for purely economic loss caused by the negligence of a wrongdoer.⁵⁶

Example 9. Economic loss. Defendant ship owner negligently causes a collision with another ship at the mouth of a river, which blocks traffic for a period of time. Numerous people and companies—ports, other ship owners, shippers, and so on—lose money as a result of the blockage.⁵⁷

The various third parties may not recover damages from the defendant because of the pure economic loss rule. A common explanation for this rule is that the losses to the third parties are offset by gains to other people in the economy,⁵⁸ for example, trucking companies that compete with river traffic. On this theory, the victims cannot recover because of benefits to third parties. But note that the defendant cannot use this argument to avoid paying damages to the owner of the ship that was physically damaged by the collision. Indeed, it could be the case that the economic benefits to third parties exceed the economic losses to victims, and the balance could have

⁵⁵ See Ariel Porat, *Offsetting Risks*, 106 MICH. L. REV. 243 (2007), which discusses some related cases. For example, in *Cooley v. Pub. Serv. Co.*, 10 A.2d 673 (1940), a court held that a telephone company that harmed a customer by emitting a loud noise while he was on the phone did not act negligently because the noise was the result of precautions that reduced the risk of electrocution to bystanders. Needless to say, that if the court had found the telephone company negligent, no offset would have been made for the benefits to bystanders.

⁵⁶ RESTATEMENT OF THE LAW, SECOND, TORTS § 766C (1979) ("One is not liable to another for pecuniary harm not deriving from physical harm to the other, if that harm results from the actor's negligence").

⁵⁷ Cf. *Louisiana ex rel. Guste v. M/V Testbank*, 752 F.2d 1019 (5th Cir. 1985) (lawsuits were brought against two ships that collided in the Mississippi River gulf outlet, causing a chemical spill and closing the outlet).

⁵⁸ See William Bishop, *Economic Loss in Tort*, 2 OXFORD J. LEGAL STUD. 1 (1982) (making the argument that a major consideration for non-recovery for pure economic losses is that those losses are often transfers of wealth from one person to another). See also Giuseppe Dari-Mattiacci & Hans Bernd Schaefer, *The Core of Pure Economic Loss*, 27 INT'L REV. L. ECON. 8 (2007) (making the same argument but explaining that non-recovery may encourage the victim to take precautions which are social costs); Mario J. Rizzo, *A Theory of Economic Loss in the Law of Torts*, 11 J. LEGAL STUD. 281 (1982) (discussing the economics of the rule against compensation for pure economic loss).

been offset against the physical harm. This possibility, as far as we can tell, has not been addressed by a court.

Our third example involves settings in which the action of a wrongdoer creates clearly identifiable transfers from those who are injured by the action to those who are benefited by the action.

Example 9. The Fiscal Agent. A fiscal agent mistakenly calculates Medicaid reimbursements, so that a state overpays a hospital. The state recovers its overpayment from the fiscal agent, which in turn obtains restitution from the hospital.⁵⁹

The state can sue the fiscal agent because the fiscal agent caused the state to overpay the hospital. When the state recovers from the fiscal agent, the hospital is now no longer liable in restitution to the state. But this means that the hospital keeps its windfall while the fiscal agent has paid damages greater than the social loss. To address this problem, the law permits the fiscal agent to avoid the loss it suffered because of its liability for the state's loss, by giving it the ability to recover the benefit from the hospital, thus eliminating the windfall. The law could provide for an equivalent result by denying the state a remedy against the fiscal agent (which is equivalent to deducting the benefit to the hospital from the harm to the state) and forcing it to obtain a recovery directly from the hospital that received the windfall.

This rule is not applied in many settings. Consider the following example.

Example 10. The prisoner. A prisoner murders another prisoner. The government provides the victim with a funeral and then sues the wrongdoer for restitution of the funeral costs. The wrongdoer argues that the government's small loss should be offset by its enormous cost savings, for it avoided the expense of feeding and sheltering the victim for the duration of his imprisonment.⁶⁰

The government in this case is like the hospital in the last case. It receives a benefit (it no longer must pay for food and shelter, which costs more than a funeral, which it would eventually have to pay for anyway), thanks to the murderer, who took the life of the victim. This would clearly be a third party case if the victim's estate brought a lawsuit against the murderer for wrongful death and sought funeral expenses, and then the murderer turned around and sued the government for restitution on account

⁵⁹ State, Dep't of Human Servs. ex rel. Palmer v. Unisys Corp., 637 N.W.2d 142 (Iowa 2001) (the State and Department of Human Services brought a lawsuit against a Medicaid fiscal agent for miscalculating payments to a health maintenance organization).

⁶⁰ U.S. v. House, 808 F.2d 508, 509 (7th Cir. 1986).

of the benefit to the government. In the actual case, the murderer's argument is in essence that the government stepped into the shoes of the estate, and if it receives damages for funeral expenses, the savings for room and board should be offset. However, the court denied the offset: the government recovered funeral expenses.⁶¹

The murderer's argument resembles a famous argument made by Kip Viscusi that states that sued tobacco companies for the cost of public medical care of people with tobacco-related illnesses should recover no damages because smokers die young and so spare the states end-of-life medical expenses that are greater than the costs of caring for people with tobacco-related illnesses.⁶² Here again the states benefit from the wrongful acts of the tobacco companies, and yet, based on a legal theory that they are entitled to step into the shoes of victims, sue the tobacco companies for damages. The Court's reluctance to allow offset would have been even stronger if the victims themselves had brought their suits and the tobacco companies had argued that the benefits to the state should reduce their liability.

Less extreme examples are also available. When a corporation fraudulently exaggerates its profitability, investors can sue based on the theory that they overpaid for the stock, and recover damages equal to the difference between the inflated price and the "true" price—the price that would have existed but for the fraud.⁶³ The corporation is not permitted to deduct from the damages the windfall to people who sold the stock to the investors and thus received a higher price than they would have obtained but for the fraud.⁶⁴ When firms conspire to fix prices, people who buy products from *non*-conspirators who are able to overcharge because of the reduced competition may be able to recover damages for these overcharges from the conspirators under the theory of umbrella liability. The damages are not reduced by the benefit to the non-conspirators who charge higher prices, nor are the conspirators given a restitution claim against the non-conspirators.⁶⁵

Or consider examples of index manipulation. A major seller, which also managers or participates in the management of a price index, enters into numerous contracts where the price is partly the function of an index. Other independent parties also set prices by reference to the index. The seller then manipulates the index so that contract prices are inflated. The

⁶¹ *Id.*

⁶² See W. KIP VISCUSI, *SMOKE-FILLED ROOMS: A POSTMORTEM ON THE TOBACCO DEAL* (2002). For criticism of this argument, see Eric A. Posner, *Review of Smoke-Filled Rooms* by W. Kip Viscusi, 70 U. CHI. L. REV. 1141 (2003).

⁶³ *Basic v. Levinson*, 485 U.S. 224 (1988).

⁶⁴ See Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 635 (1985) ("These gainers have not violated any rule, however, and cannot plausibly be called on to pay their gains to the losers.").

⁶⁵ See PHILLIP E. AREEDA & HERBERT HOVENKAMP, *ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION* (1978).

seller's counterparties, who paid more than they bargained for, are obviously entitled to recover for damages. But what of buyers who are not counterparties of the seller? They could sue their own sellers for restitution but instead they sue the manipulator in tort. It is not clear whether the windfall to the non-counterparty sellers will be deducted from the damages that the non-counterparty buyers can recover from the manipulator.⁶⁶

Our final example comes from the law of takings.

Example 11. Takings. The government takes a piece of Owner's land and redevelops it. As a result, the value of the land of Owner's neighbors increases. Should Owner's compensation for the taking be reduced by the benefit to the neighbors?

Black letter law says no—Owner's compensation should not be affected by the benefit to the neighbors.⁶⁷ However, in practice the contrary result sometimes occurs. For example, in *Penn Central Transportation v. New York City*, the owners of Grand Central Terminal unsuccessfully sought compensation for a taking caused by a landmark preservation law that prevented them from building atop the existing structure. The Supreme Court held that the owners were compensated by reciprocal economic and "lifestyle" benefits created by the law. As Daryl Levinson explains,

These benefits would hardly be sufficient to compensate the owners for their enormous economic loss; as the Court recognized, the owners may have been personally "more burdened than benefited" by the landmark preservation law. Nevertheless, the Court suggested, average reciprocity of advantage might obtain at the level of "all New York citizens," a group that includes the beneficiaries of historic preservation along with the immediate economic losers. As long as the benefits of regulation are at least equivalent to the costs across all members of this group, the argument would go, there has been no taking requiring compensation. The distribution of costs and benefits within the group, on this theory, is of no consequence: Benefits and burdens need not net out nonnegative at the level of any particular individual.⁶⁸

The reciprocity language masks the fact that the owners receive no

⁶⁶ *Loeb Indus., Inc. v. Sumitomo Corp.*, 306 F.3d 469 (7th Cir. 2002): one of us (Posner) is involved in a case involving this issue.

⁶⁷ *See, e.g., Hendler v. United States*, 175 F.3d 1374 (Fed. Cir. 1999) (noting the rule that "general benefits" to the community are not offset from damages; only "special benefits" to the owner are).

⁶⁸ Daryl J. Levinson, *Framing Transactions in Constitutional Law*, 111 YALE L.J. 1311, 1341 (2002); *see also* Abraham Bell & Gideon Parchomovsky, *Givings*, 111 YALE L.J. 547 (2001) (pointing out that benefits as well as costs should be taken into account when determining damages for takings).

compensation because third parties receive a benefit.

B. Theory

1. Social vs. Private Costs and Benefits

In the injured passenger case (Example 6), we have three persons: the driver who drove too fast, the pedestrian who was injured, and a passenger who was saved. The driver injured the pedestrian but benefited the passenger. From a social perspective, we want the driver to pay the net cost that he imposed on all others—the pedestrian *and* the passenger—and that means that the driver must pay damages that equal the cost to the pedestrian minus the benefit to the passenger.⁶⁹ In other words, the private cost of the pedestrian is more than the aggregate social cost. As we have explained, the law should ensure that the wrongdoer pays the social cost, not the private cost.

The law can ensure that the wrongdoer pays only the social loss in two main ways. For clarity, suppose that the loss to the pedestrian is 100 and the gain to the passenger is 80. The social cost is thus 20. First, the wrongdoer could pay the pedestrian damages equal to the net social cost of 20, leaving the pedestrian undercompensated. (The pedestrian could also be given a right of restitution of 80 against the passenger.) Second, the wrongdoer could pay the pedestrian damages equal to her private cost of 100, and be given a right of restitution of 80 against the passenger.

It is clear that the different rules can result in different allocations of the loss between the pedestrian and the passenger. If the wrongdoer pays damages of 20 to the pedestrian, and the pedestrian has no remedy against the passenger, then the outcome is one in which the pedestrian loses 80 and the passenger gains 80 against the pre-accident status quo. Alternatively, suppose the wrongdoer pays damages of 100 to the pedestrian and has a right of restitution of 80 against the passenger. Then the outcome is a loss of 0 for the pedestrian and a gain of 0 for the passenger against the status quo. Other sharing rules can also be imagined. We return to the question of how damages can be allocated so as to give victims and beneficiaries the proper incentives in Section 4.

Consider now the fiscal agent case (Example 9). When the fiscal agent makes a mistake, the state transfers, say, an extra \$100 to the hospital. The state sues the agent, arguing that it lost \$100. But to calculate the social loss, we must subtract the hospital's \$100 benefit from the state's \$100 loss. Thus, the fiscal agent should not be liable. If it is important for the state to be compensated, then it should have a restitution claim against the

⁶⁹ If the benefit to the passenger (for example, life saved) exceeds the cost to the pedestrian (for example, broken ankle), damages should be zero, or conceivably negative, as we will discuss.

hospital; or, if it is permitted to recover from the fiscal agent in tort, then the fiscal agent should have a restitution claim against the hospital to the extent of its liability. Here, the law is consistent with the efficient outcome.

Courts do not account for the benefit to the passenger (either by reducing the driver's damages or giving the driver a restitution claim against the passenger), but they do account for the benefit in the fiscal agent case. These outcomes are plainly inconsistent.⁷⁰ If social rather than private losses should be counted, then the outcome in the fiscal agent case is correct, and similarly the wrongdoer should receive credit for the benefit to the passenger.

The Penn Central case also illustrates the idea that social rather than private losses should be counted.⁷¹ Let us make some very simple assumptions about the government.⁷² When it takes property, it must pay whatever the court orders it to pay. But it does not benefit from gains to neighboring property that result from development of the taken property. (Or it gains only partially, from tax revenues.) If the government attempts to balance its budget, and it must pay the owner's entire private loss, then it will not make socially optimal takings that benefit third parties. Penn Central corrects this problem by allowing the government to take for free when the benefits to third parties are great enough.

Penn Central muddied this result by purporting to base the outcome on the supposed reciprocal benefits to the owner (even while acknowledging that the owner is not fully compensated by those reciprocal benefits). However, the underlying logic of Penn Central implies that the government should not pay compensation whenever the benefits to third parties from a taking exceed the costs to the owner. For example, if the government takes houses in order to build a road, and the benefits are greater than the costs, it should not pay damages because the "reciprocity of advantage," to use the term from Penn Central, is achieved. As we saw, the usual explanation for requiring the government to compensate the owner in all cases is that if the government is not forced to pay the costs of takings, it will take too often. But this explanation ignores the fact that government officials do not internalize the benefits as well as the cost. If the government simply tries to balance its budget, and must compensate the owner for a taking while not receiving the benefits to third parties in the form of a restitution claim, then the government will take too rarely. One might reconcile this doctrinal tension by positing that if benefits are spread across many people, there

⁷⁰ As we discuss below, there may be other explanations for the outcome in the injured passenger example.

⁷¹ Text accompanying note 68.

⁷² The government's possible motives in such cases are the subject of a large literature. See, e.g., Lawrence Blume & Daniel L. Rubinfeld, *Compensation for Takings: An Economic Analysis*, 72 CALIF. L. REV. 569, 620 (1984) (discussing fiscal illusion and related phenomena). We adopt the present assumptions for illustrative purposes only.

will be greater political pressure to take too much than to take too little.⁷³ We are skeptical, but in any event these political issues lie outside the scope of this paper.

2. *The Problem of Residual Harms*

The distinction between social and private losses—where social losses are private losses minus benefits to others—is found in many areas of the law, where offsets are recognized. But the law does not always respond consistently, and one hypothesis for why is that it must grapple with what we call the problem of residual harms.

In our economic loss cases (Example 8), when the ships collide and block the river mouth, other shipping companies are harmed but competing trucking companies are benefited. Thus, when shipping companies sue for damages, they are awarded zero because the benefits to others offset their losses. This is required by the economic loss doctrine.

But consider the case of corporate fraud. The CEO of X Corp. announces at time 1 that the company has discovered gold. The stock price soars from 10 to 20. At time 2, an investigation reveals that the CEO had lied; the stock falls back to 10. Investors who bought stock in X Corp. after the announcement at time 1 paid \$20 per share, but now own stock worth \$10 per share. They sue X Corp. for the difference—damages of \$10 per share.

The investors are entitled to these damages under the law. However, as we noted before, their private loss does not equal the social loss. Another set of investors benefited from the fraud: they sold shares worth \$10 at \$20. If their benefits were subtracted from the losses to the other investors, then the net would be \$0. From a social perspective, the fraud appears to cause no harm at all.

But this is not quite right. If investors know that CEOs can lie about the company, then they will be reluctant to buy stock—or they will buy stock only at a low price.⁷⁴ This means that when corporations raise capital, they must pay a premium above what they would pay if CEOs are deterred from lying—an amount that compensates investors either for the higher risk that they take that management wrongdoing or error will be concealed or the greater efforts they will take to obtain information from other sources. In our example, this premium is neither \$0 (the ex post social loss) nor \$10 (the ex post private loss); it is most likely something in between. The correct figure depends on all kinds of complicated factors. Suppose, for example, that a firm's business is largely public, and so CEOs do not have much private information. (Consider, for example, the CEO of an exchange whose members are major firms, or the CEO of a mutual fund

⁷³ Blume & Rubinfeld, *id.*, at 620.

⁷⁴ See Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669 (1984).

that approximates an index of publicly traded companies.) Then CEO fraud is not much of an issue, and if it occurs, will not cause much harm. By contrast, where CEOs possess private information that matters to the value of the firm, investors will want to be able to rely on statements by the CEO, in which case the absence of an effective fraud remedy will greatly raise the cost of capital for the firm. This same point applies to our index manipulation example,⁷⁵ and it echoes our analysis of the economic loss case (Example 8), where again potential victims will take precautions to avoid their private loss, and those precautions create a social loss even if otherwise economic losses and benefits from a tort net out.

In sum, the problem with offsetting benefits in the present context is that it may result in zero damages when the social cost of the wrongdoing is positive albeit not as high as the private loss. We think that in these cases courts should offer at least a partial offset by allowing the wrongdoer to obtain restitution from the beneficiaries equal to the benefit minus the social harm. When the social harm is thought to be large but cannot be precisely calculated, a case can be made that benefits should not be offset.⁷⁶

3. *Ex-Ante Increase of Expected Benefits*

As in the two-party case, a benefit should not be subtracted from a loss for the purpose of calculating damages when the probability of the benefit's creation was not increased by the wrongdoing.⁷⁷ In the passenger case (Example 6), imagine that in most of such cases, the passenger would have been taken (safely) to the hospital by an ambulance if the driver had not acted, and would receive the same benefit or even larger one (getting faster to hospital, with immediate medical treatment). In the robber case, imagine that in most such cases the police would have arrested the robber if the third party had not intervened and benefitted the victim.

This principle provides an important and pervasive constraint on restitution damages. It is often the case that benefactors cannot obtain restitution from a beneficiary. The doctrinal reason is that the benevolent act was gratuitous.⁷⁸ The underlying economic reason is that if the beneficiary had not acted, the beneficiary would have purchased the good or service on the market, or the government would have supplied it.⁷⁹ Moreover, it is plausible that the market and the government provide goods and services more efficiently than random benefactors do. Thus, the gratuitousness rule deters people from inefficiently supplying goods and services, or providing goods and services that others do not in fact want.

⁷⁵ *Supra* text accompanying note 66.

⁷⁶ This is technically a problem with measurement; *see infra* Part II.B.5.

⁷⁷ *Supra* Part I.B.2.

⁷⁸ *See* Levmore, *supra* note 41 (explaining the logic of no liability for unrequested benefits).

⁷⁹ Levmore, *id.*

This principle carries through to our three-party case. Suppose, for example, that ambulance services are plentiful and reliable in the area where the passenger had a heart attack. To encourage the driver to pull over and call an ambulance, or in any other way to cause the driver to internalize all social costs, the law should require him to pay the full (private) loss to the pedestrian if an accident occurs, and deny him a right of restitution against the passenger. But if ambulances are not available, the law should calculate damages by subtracting the benefit to the passenger from the cost to the victim, so as to provide optimal incentives.

This may be an excessively complicated way of noting that one must take account of context. When an apparent benefit (driver saves passenger) is not a real benefit (ambulance would have saved passenger), then obviously the benefit should not be offset. Our larger point is that courts must pay attention to the context in order to determine whether the apparent benefit is real or not. Moreover, the existence of background substitutes helps explain why the norm is not to offset benefits.

4. *Victim's and Beneficiary's Incentives*

As is well-known, if the victim is fully compensated, she may take insufficient precautions to protect herself from the accident. This problem can be addressed at the level of liability: if the wrongdoer does not pay if he is non-negligent, or the victim does not receive damages if she commits contributory negligence, then she will have the optimal incentive to take precautions.⁸⁰ However, in some cases—for example, if the victim's behavior cannot be verified in court, or the tort rule is strict liability—damages should be reduced to ensure that the victim takes precautions.⁸¹ A rule that gave the victim damages equal to the social loss rather than her private loss (when the social loss is smaller than the private loss) would nudge her to take precautions. Thus, an argument could be made that the benefit to the passenger in Example 6 should be offset from the damages the driver must pay to the pedestrian, and that the pedestrian should not have a right of restitution against the passenger.⁸²

However, we also need to take into account the beneficiary's incentives. Imagine that the passenger had a heart attack on the side of the road, and was about to dial 911 when the driver pulled up and offered her a ride to the hospital. Suppose the ambulance would cost \$100, while the driver offers a ride for free, but the ambulance imposes an expected risk on pedestrians of \$0 while the driver imposes an expected risk on pedestrians

⁸⁰ See STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 184-87 (2004) (analyzing victims' incentives under different liability rules).

⁸¹ Shavell, *id.*, at 184 (arguing that strict liability with no contributory negligence defense provides the victim with deficient incentives to take care).

⁸² The same argument applies also to two-party cases: decreasing the victim's liability below his private loss could often improve his incentives. See *supra* Part I.B.3.

of \$200. Otherwise, the driver and the ambulance offer an identical service in terms of speed, safety to the passenger, and so on.

In the absence of a legal rule that creates liability for the passenger, she will choose the driver over the ambulance because the driver offers the ride for free. In doing so, she effectively (albeit jointly with the driver) externalizes a cost on pedestrians. To prevent her from doing so, the law should impose an expected liability of \$200 on her (or on the driver). In principle, the passenger should be exposed to tort liability, but proximate causation would probably spare her. A second best outcome would be to give either the driver or the pedestrian a right to restitution against the passenger. The exact amount of restitution raises further questions. It could be the cost savings from avoiding the ambulance (\$100), or it could be the health benefits (\$80). In the context of this example, restitution should be at least \$100, so as to cause the passenger to choose the ambulance.

The basis for this argument is that we want all parties to internalize both negative and positive externalities. The beneficiary internalizes the positive externalities; he should ideally internalize also the negative externalities. A second best is that he would disgorge the benefits he received (as long as harm is higher than benefit, disgorgement of benefits is clearly an improvement from a situation when he pays nothing)

5. Measurement Issues

Measurement issues in three-party cases are similar to those in two-party cases so we need not repeat our earlier discussion.⁸³ It is sufficient to note again that the frequent difficulty of measuring benefits provides a reason for denying restitution or for not offsetting benefits in three-party as well as two-party cases. Indeed, the residual harm issue, the ex ante increase in benefit issue, and the victim/beneficiary incentive issue can all be described as issues that implicate measurement problems. For example, the residual harm issue is that the residual harm often cannot be measured. In such cases, it may make sense not to allow the wrongdoer to offset benefits, for if the law allowed him to do this, he would be underdeterred.

6. Interlinking Non-Compensable Harms

Should the prisoner case (Example 10) have the same result as the fiscal agent case (Example 9)? Recall that in the fiscal agent example, the fiscal agent should recover restitution from the hospital if it must pay damages to the state on account of a transfer from the state to the hospital. The benefit to the hospital must be offset from the loss to the state. The prisoner example is different because the victim (who is dead) does not recover damages from the prisoner. The state, which has an interest in keeping prisoners alive (even though they are in prison and must be

⁸³ *Supra* Part I.B.4.

maintained at great expense), steps into the victim's shoes and rightly demands money so as to deter future prison murders. If the government could successfully recover full compensation for the victim's death, then an argument could be made that room and board savings should be reduced. But since it can't, funeral expenses provide at least a small deterrent. In other words, if the government (or victim's family) does not recover the victim's private loss, and so wrongdoers are underdeterred, it would make no sense to offset benefits to the government in a separate action to recover restitution for funeral expenses. The same analysis applies to Viscusi's argument about tobacco litigation.⁸⁴

7. Activity Levels and the Asymmetry Problem

Consider again the injured passenger case (Example 6). Suppose the driver can choose between two routes to the hospital: a populated route and a safe route. If the driver takes the populated route, he imposes a risk on pedestrians; if he takes the safe route, he does not. Suppose now that the law gives the pedestrian the right to recover in tort against the driver and the driver the right to recover in restitution against the passenger. Then the driver will speed if and only if the benefit to the passenger exceeds the cost to the victim. This was the result of our earlier analysis.

The problem, however, is that the driver doesn't get a right to recover against the passenger if he takes the populated route and injures no one. To understand this point, suppose the two routes get the passenger to the hospital in exactly the same time (giving the passenger a benefit of \$80), and the driver should choose the safe route. If he takes the populated route, he imposes an expected cost of \$50; if he takes the safe route, he imposes an expected cost of \$0. Now if an accident occurs, he must pay the victim \$50 but may offset the benefit or separately obtain restitution from the passenger, so that his liability is \$0. This means that the driver is indifferent between the safe route and the populated route—in both cases his liability is \$0. But we want the driver to take the safe route.

This problem arises from an asymmetry: If we credit injurers who create benefits without crediting non-injurers who create benefits, we bias behavior in favor of injuring. In other words, a rule that allows wrongdoers to offset benefits from private losses can distort behavior because no rule allows non-wrongdoers who create benefits to obtain restitution for those benefits.

There are three ways to solve this problem. The first is to allow people who provide benefits to obtain restitution even if they are gratuitous. But as we have seen, the law has good reasons not to allow this.⁸⁵ The second is to make sure that the pedestrian can obtain restitution from the passenger, so

⁸⁴ See Posner, *supra* note 62.

⁸⁵ *Supra* text accompanying notes 78-79.

that the passenger will order the driver to take the safe route. But this seems a bit complicated. The third is to forbid wrongdoers after all to deduct benefits from damages. But if this is done, then, as we have seen, deterrence will be excessive. A possible middle path is to permit restitution only in limited circumstances—for example, when the wrongdoer can prove that this distortion is not likely—or to limit the magnitude of restitution damages. But we again see why courts may be reluctant to award restitution too freely.

Or consider another example. Suppose, Jones, the wealthy resident of a neighborhood, would like to build a large park on her property that she will allow neighbors to use and enjoy. These neighbors would value the park at 100. But other neighbors would be irritated by the noise that occurs when people use the park, and the harm to these other neighbors would be 100. Jones could build the park in a slightly different way that would minimize the noise, but the cost of building the park would then be slightly higher.

If the offended neighbors can sue Jones for nuisance but their damages would be completely offset by the benefit to the other neighbors, then Jones has no reason to spend slightly more to build the quiet version of the park. From the social perspective, however, Jones should build the quiet version of the park.

Again, the problem arises because of the law's different treatment of injurers who create benefits (and enjoy a deduction) and non-injurers who create benefits (who do not receive restitution). The problem arises only in the special case when people voluntarily create benefits. The problem does not arise in a market setting. If Jones plans to build a park and then charge people for admission, she will take into account the harm to neighbors because her liability to them will be subtracted from her profits.⁸⁶

8. Summary

Our starting point was that, all else equal, the wrongdoer should be liable for the social loss, not the private loss, where the social loss equals the private loss minus any private benefits. The residual private loss should be allocated between the victim and the beneficiary. As we have seen, the law does provide for such an outcome some of the time. Our puzzle was why it doesn't do so more often. And the answer to that puzzle, painting in broad terms, is that not all else is equal: numerous factors provide reasons for denying the offset. These include: (1) the victim does not recover her full private benefits because of factual or legal limitations; (2) there are residual harms, so that deduction of private benefits would lead to underdeterrence of wrongdoing; (3) the private benefit would have been

⁸⁶ Note that this point is also relevant to two party cases. If the same neighbor who suffers a loss of 100, also receives another benefit of 100, and offset is allowed, Jones' incentives will be distorted in the same way as in the three-party case.

supplied more efficiently by the market or the government; (4) deduction of the private benefit would give victims and beneficiaries perverse incentives; (5) private benefits can be hard to measure; (6) the benefit might be offset by a hard-to-measure harm to the victim; and (7) deduction of private benefits can lead to activity-level distortions. By the same token, when these problems do not exist—as is most clear in the fiscal agent example, and perhaps in certain eminent domain cases—a strong case for deducting the benefits of third parties exists.

Assuming that the benefit should be offset, *how* should it be offset? We saw two main approaches: give the victim a right to damages for the entire loss while giving the wrongdoer a right of restitution against the beneficiary; and give the victim a right to damages only for the social loss while giving her also a right of restitution against the beneficiary. The first approach thus puts the burden on the wrongdoer, while the second approach puts the burden on the victim.

It might seem intuitive that the wrongdoer should bear the burden, but the law does not always impose such ancillary costs on wrongdoers (for example, they do not generally pay victims' attorney's fees), and if we are concerned about incentives, that is where our focus should be. The choice between the two approaches matters from a social standpoint only when the beneficiary is judgment proof—insolvent—or effectively so, as when numerous small beneficiaries are too costly to identify and sue, or when there are substantive reasons not to allow recovery from a beneficiary who received unrequested benefits. In the securities fraud example,⁸⁷ the investors who benefited from the fraud because they sold to the victims when the price was artificially inflated probably cannot be identified, and would be difficult to sue even if they can. If the wrongdoers must pay the victims' full loss with no offset, and are given a (worthless) restitution right against the beneficiaries, overdeterrence will deter. If the wrongdoers must pay only the social loss (zero, or a small residual amount), and the victims are given the worthless restitution right, optimal deterrence will occur but the victims will be undercompensated. So the choice between the two approaches depends on how much one weighs the risk of overdeterrence and the harm from undercompensation. Since victims are generally diversified, and thus effectively have insurance against such losses (which are usually small relative to their portfolio), it seems that the second approach of giving victims the restitution right is correct.⁸⁸

⁸⁷ *Supra* Part II.B.2.

⁸⁸ Unless, as we argued above *supra* Part II.B.2, the residual loss cannot be calculated, and overdeterrence is superior to underdeterrence.

Table 2: Summary of the Three-Party Analysis

	Social Benefit?	Resid. Harms	Ex-Ante Increase?	Victim's incentives problem?	Measurement Problems?	Interlinking Harms?	Activity Level
Injured Passenger	yes	no	maybe	maybe	no	no	maybe
Defense of Another	yes	no	maybe	yes	yes	no	usually irrelevant
Economic Loss	no	maybe	yes	yes	no	yes	usually irrelevant
The Fiscal Agent	no	yes	yes	no	sometimes	no	usually irrelevant
The Prisoner	no	no	yes	sometimes	no	no	usually irrelevant
Takings	no	yes	yes	no	yes	yes	usually irrelevant

CONCLUSION

Wrongdoing often creates harms and benefits at the same time. Victims seek damages that compensate them for the entire harm, while defendants try to persuade courts to offset benefits that the victims or third parties received as a result of the same act that caused the harm, or acts related to the original wrongdoing. The recurrent question is when should the benefits be offset?

Our starting point was the assumption that the law should minimize social costs, and it immediately follows that the benefit should be offset from the harm as long as the benefit was itself not offset by another harm (that is, the benefit is social rather than private), and the wrongdoing increased the probability of the creation of the benefit. But even when these two conditions are satisfied, there are several considerations that could tilt the scale toward the conclusion that offset should not be made.

First, the court must ensure that offsetting the benefits does not give the victim perverse incentives, for example, incentives not to avoid the harm or not to mitigate it. Second, the court should probably avoid offsetting benefits when they are too hard to measure. Third, and related, the court should avoid offsetting measurable benefits that are plausibly offset by harms that are not compensated because those harms are too hard to measure. Fourth, the court should not offset benefits when doing so gives wrongdoers an incentive to inefficiently increase their activity level. In third-party cases, courts also need to ensure that if they do offset benefits, they also order the wrongdoer to pay damages equal to the residual harm. If the residual harm is difficult to measure, offsetting

benefits may be unwise.

Three-party cases also raise the question as to the form that the offset should take. Often, there is a choice as to whether to reduce the wrongdoer's liability and give the victim a right to restitution against a beneficiary, or to maintain the wrongdoer's liability to the victim while giving the wrongdoer a right to restitution against the beneficiary. The choice boils down to who should bear the risk that the beneficiary is judgment-proof, or for some other reason cannot be sued. If the beneficiary is judgment-proof or otherwise cannot be sued, the first approach leads to undercompensation of the victim, while the second approach leads to overdeterrence of the wrongdoer.

Interestingly, the law typically allows third-party effects to be taken into account in setting the standard of care, but not in awarding damages. The driver who crashes into one pedestrian because she swerved to avoid another avoids liability if she acted justifiably but must pay full damages if not, even though she benefited the second pedestrian. Perhaps this rule reflects intuitions about corrective justice, which implies that third party considerations should be disregarded altogether once liability has been established.⁸⁹ However, the lens of corrective justice is too narrow. The law frequently rewards people who benefit others in order to provide socially beneficial incentives. Cases like the Fiscal Agent (Example 9) show that the social goals of remedying harm and rewarding benefits are often implicated by a single act. Thus, we believe courts should seriously consider offset arguments in third party cases.

Still, one of the lessons of our discussion is that the general legal reluctance to offset benefits is frequently justified. Even when the benefits are social, numerous complex issues touching on causation and measurement must be confronted.

⁸⁹ JULES L. COLEMAN, *RISK AND WRONGS* 380-85 (1992) (discussing the focus of corrective justice on the relationship between the injurer and the victim); ERNEST J. WEINRIB, *THE IDEA OF PRIVATE LAW* 63-66 (1995) (same).

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