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Recommended Citation
40 Ala. L. Rev. 1229 (1989)

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Punitive Damages: A Supporting Theory

*Harold See**

All the contributors to this Symposium would agree with a doctrine that awards *compensatory* damages. There would be scant disagreement with a policy of awarding damages, in addition to normal compensatory damages, that are even more *fully compensatory* in nature (to compensate for litigation costs, inconvenience, injury to dignity, or other social harm). Apparently, a "punitive" (in the individual case) *adjustment* component would pass without objection, if carefully designed only to adjust for the number of instances that the wrong goes undetected or unpunished (and, perhaps, if limited to an inducement fee to go to the individual, with the balance to accrue to the state). Let us call these alternatives compensatory, fully compensatory, and adjusted compensatory, damages.

It is my reading of the symposium papers, however, that scholarly opinion overwhelmingly opposes the trend toward truly punitive damages.[1] If Lord Keynes's observation is correct,[2] then damages intended to punish are, after only a brief maturity, condemned to pass away. The winds of the popular and judicial

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1. For what may be read as a contrary view, see Phillips, *A Comment on Proposals for Determining Amounts of Punitive Awards*, 40 ALA. L. REV. 1117, 1117 (1989) ("There seems to be a consensus that a punitive damages remedy in some form is useful and desirable and should be retained."). However, Professor Phillips's consensus on punitive damages is semantic in that he is using the term "punitive," as do most of the conference participants, to describe awards that are fully compensatory or adjusted compensatory. His own article, while more an attack on the criticisms of punitive damages than it is an affirmative proposal, does suggest considerable flexibility in punitive damages awards: "[A] fixed or certain penalty tends to be Procrustean and fails to take account of the degree of fault of the individual defendant and the amount of harm done." *Id.* at 1120.

2. "[T]he ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else." J. KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 383 (1935); *but see* Ellis, *Punitive Damages, Due Process, and the Jury*, 40 Ala. L. Rev. 975, 977 (1989) ("In this Article, I accept that the judicial tide supporting the expanded availability of punitive damages will not soon recede.").

summer will carry them off because there is no hedgerow of theory to break that wind and hold them fast.

The analysis on which most of the participants rely is economic analysis. This is appropriate. Tort law is concerned with economic phenomena, and specifically, the acts that give rise to significant punitive damages awards increasingly are economic activities.[3] Money damages are sought. And, the practice of law that shapes the law, judgments, and settlements is a business by which people earn their livelihoods. The economic analysis of punitive damages is well developed in the papers of this symposium, and economic analysis is clear in its implications. If a doctrine of truly punitive damages is to survive, it must have a theory to protect it, and it appears from this symposium that that theory cannot be an economic theory.[4]

I propose such a noneconomic theory. As an economist, I frankly have trouble understanding noneconomic arguments, and, even when I do, I understand them in analog economic terms. Nonetheless, when no one else appears, people usually accept even the most dubious of friends. I do not purport to offer a fully developed "noneconomic" theory, but what I do offer is a sketch and example of such a theory. Better champions than I are invited to give the theory substance.

First, the alternative theory is labeled a "noneconomic" theory. There is another possibility abroad: the "antieconomic" theory.[5] It is frequently argued, as Professor Phillips briefly argues,[6] that the economic model is not useful because people do not behave in a "rational, economic" way. Such a position is self-defeating. Note that in the paragraph immediately following his

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3. M. PETERSON, S. SARMA AND M. SHANLEY, PUNITIVE DAMAGES: EMPIRICAL FINDINGS 19 (RAND 1987).

4. Friedman's theory of optimal deterrence in the presence of "external" costs does justify small positive (or negative) punitive awards. Friedman, *An Economic Explanation of Punitive Damages*, 40 ALA. L. REV. 1125 (1989). Phillips argues for punitive awards on the basis that they are deserved, but his article cannot reasonably be read as a theoretical basis for such awards. *See supra* note 1.

5. *See, e.g.*, Kelman, *Cost-Benefit Analysis and Environmental, Safety, and Health Regulation: Ethical and Philosophical Considerations*, in COST BENEFIT ANALYSIS AND ENVIRONMENTAL REGULATION: POLITICS, ETHICS, AND METHODS 137 (D. Swartzman, R. Licoff & K. Croke eds. 1982); *see also*, Owen, *The Moral Foundations of Punitive Damages*, 40 ALA. L. REV. 705, 732-33 nn.94-96 (1989).

6. *See* Phillips, *supra* note 1, at 1118.

rejection of rationality, Phillips relies on rational behavior to support his conclusion that larger damages awards deter more.[7]

In contemporary Western society any argument premised on irrationality must fail because ultimately we judge arguments by their rationality. More specifically, an argument that does not permit punitive damages to affect behavior in some consistent way leaves itself precious little with which to justify itself. If it does not have a more or less consistent effect on someone's behavior, why do we go to the trouble of transferring money from person A to person B? If the wealth transfer makes one person happy and the other unhappy, why? Is it because rationally each prefers to have money? Will they not seek happiness and avoid unhappiness? Isn't that rational economic incentive the reason they bring suit? The reason the lawyer undertakes the case? Can the antieconomic theory sustain itself without economically driven plaintiffs? Without economically driven lawyers?

I suspect that a logically consistent antieconomic system could be constructed, but I also suspect it would appear counterfactual and therefore find few adherents. A *non*economic theory, however, might admit the market system of law and the legal system of markets, and still find a compelling noneconomic rationale that justifies the apparent inefficiency of punitive damages.

For traces of such a rationale, I turn to the Owen and Phillips articles. In their language I find two possible rationales: harm and fault. The harm principle, if it is to support punitive damages awards, must be more than that one is accountable for the harm one does, for that is the principle of compensation. Rather, the harm principle to which Phillips subscribes appears to be that one must do *no* harm.[8] This is an attractive rule, and it has many familiar corollaries. It is my first rule of teaching that students should not leave the class less educated than when they came in. My father often said, "If a job is worth doing, it is worth doing right." A number of other familiar sayings illustrate this harm principle: "If you find yourself in a hole, stop digging"; "If it ain't broke, don't fix it"; and "Leave well enough alone."

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7. *Id.* at 1122. In fact, of course, if one has only a thousand dollars, there is no reason a rational person would be more deterred by a two-million dollar penalty than by a one-million dollar penalty. *See also id.* at 1119.

8. *See* Phillips, *supra* note 1, at 1120 ("The injured plaintiff should be entitled to recover these ill-gotten gains, as well as his compensatory damages.").

Consider *Grimshaw v. Ford Motor Company*,[9] the Ford Pinto case. Richard Grimshaw was badly burned when the Pinto in which he was a passenger stalled on the freeway and was struck from the rear by another car traveling at a relatively high speed. On impact the fuel tank ruptured, gasoline spilled into the car, and the car burst into flame. The driver died, and Grimshaw was badly burned. The jury awarded Grimshaw compensatory damages of $2,841,000 and punitive damages of $125,000,000. The court denied Ford's motion for a new trial on the condition that Grimshaw remit all but $3.5 million of the punitive award. Both parties appealed. Because of the astronomical (at the time) size of the initial punitive award, *Grimshaw* is thought by many to mark the new era in punitive damages awards.

It is clear that the California Court of Appeal accepted the do-no-harm rationale for punitive damages:

> The primary purposes of punitive damages are punishment and deterrence of like conduct by the wrongdoer and others. In the traditional noncommercial intentional tort, compensatory damages alone may serve as an effective deterrent against future wrongful conduct but in commerce related torts, the manufacturer may find it more profitable to treat compensatory damages as a part of the cost of doing business rather than to remedy the defect. Deterrence of such "objectionable corporate policies" serves one of the principal purposes of [California's statutory punitive damages]. Governmental safety standards and the criminal law have failed to provide *adequate* consumer protection against the manufacture and distribution of defective products.[10]

Clearly the court viewed the existence of an injury as demonstrating that consumer protection is not *adequate*. That is, even with regulation and criminal sanctions in place, still business has not met the do-no-harm standard, and therefore additional deterrence is justified.

The do-no-harm standard is an attractive rule. Certainly none of us wishes to see others harmed. But, the standard is unworkable. Without harm there is no success: "Show me someone who doesn't make mistakes, and I'll show you someone who doesn't do anything."[11]

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9. 119 Cal. App. 3d 757, 174 Cal. Rptr. 348 (1981).
10. *Grimshaw*, 119 Cal. App. 3d at 810, 174 Cal. Rptr. at 382 (emphasis added).
11. *See* Owen, *supra* note 5, at 724.

If we punish people for all harm they cause, we will be punishing (beyond mere compensation, which is not at issue) everyone who attempts anything. If we do so by the transfer of money, from those who act to those who are harmed, we will be engaging in a multitude of transfers and rewarding those who attempt nothing. If we deter all activity that can result in harm, we will have deterred all activity.

If the do-no-harm principle is valued highly enough, then as a society we may impose punitive damages on everyone who does harm, but that would create a totally different, and probably subsistence, society. A do-no-harm society would require tremendous sacrifices of material well-being. This society probably is not prepared to do that. And, if it does so, it may be unable to maintain its independence from the domination of more powerful risk-taking societies. I do not believe we yet hold such a value; however, the rise in frequency and quantity of punitive awards may be a manifestation of our attraction to the do-no-harm standard.

The second rationale that possibly could support punitive damages is the fault rationale.[12] Fault, however, is a treacherous concept, more in the nature of a conclusion than of a premise. In his landmark article, "The Problem of Social Cost," Richard Coase points out that *cause* does not assign fault.[13] It takes both the pedestrian and the automobile to create the accident: were either not there, there would have been no accident. Absent value judgments, therefore, each is the cause. This may be most effectively brought home to us in *Spur Industries, Inc. v. Del Webb Development Co.*,[14] in which a developer built homes near a cattle feed lot. Who caused the problem—the feed lot owner who had been there for years, or the developer? Persuasive arguments can be mustered each way. But the point is distinct from the arguments. The point is that the cause—and thus the fault—that we see is based on our value system. Of course the motorist, factory, shopowner, etc., is at fault, because other values we hold tell us that.

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12. *See* American Bar Association Special Committee on the Tort Liability System, Towards a Jurisprudence of Injury: The Continuing Creation of a System of Substantive Justice in American Tort Law 4-154 (1984) ("[T]here is elementary justice in the principle of the tort action that he who has by his fault injured his neighbour should make reparation.") (quoting 1 Royal Commission on Civil Liability and Compensation for Personal Injury (The Pearson Commission) 65 (1978)).

13. Coase, *The Problem of Social Cost*, 3 J.L. & Econ. 1, 2 (1960).

14. 108 Ariz. 178, 494 P.2d 700 (1972).

A theory of punitive damages based on fault, then, cannot be based simply on *cause*. It must look to another standard based on some articulable value. Champions of punitive damages may find such a value (or set of values) on which to base the theory. I hope, however, they will indulge me a suggestion.

In the *Grimshaw* case the court makes a great deal of Ford's knowledge:

> There was evidence that Ford could have corrected the hazardous design defects at minimal cost but decided to defer correction of the shortcomings by engaging in a cost-benefit analysis balancing human lives and limbs against corporate profits. Ford's institutional mentality was shown to be one of callous indifference to public safety. There was substantial evidence that Ford's conduct constituted "conscious disregard" of the probability of injury to members of the consuming public.[15]

Clearly, the court is imposing the do-no-harm standard, but there is something more in this passage: Ford knew what it was doing. The reason for such language is that the normal standard for the imposition of punitive damages requires conduct that is "willful and wanton" or, in accordance with Owen's standard, "in conscious or reckless disregard of the rights of others."[16] If Ford didn't know, then it would not have been found liable.

But do we want a standard that finds Ford's wrong in the fact that it knew what it was doing? Under such a standard, had Ford never done any crash tests, had it not placed human lives in the balance at all, then it would not have been subjected to punitive liability. Such a reading punishes Ford for being thoughtful rather than careless.[17] Surely this is not the doctrine we want to impose: if a product is put on the market in ignorance of what harm may occur, one need pay only compensatory damages; but, if one is more responsible, if one considers the harm the product may cause and then decides that the benefits of the product outweigh the costs, then one may be subjected to an open-ended punitive award.[18]

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15. *Grimshaw*, 119 Cal. App. 3d at 813, 174 Cal. Rptr. at 384.
16. Owen, *supra* note 5, at 730.
17. There are those who favor action in ignorance. *See* Kelman, *supra* note 5, at 149.
18. Wheeler, *A Proposal for Further Common Law Development of the Use of Punitive Damages in Modern Product Liability Litigation*, 40 Ala. L. Rev. 919 (1989), suggests that such balancing, is "proper, socially desirable, and required by law." *Id.* at 953.

Not only is such a reading of *Grimshaw* unappealing, it conflicts with the standard of liability established by the California Supreme Court in product liability cases:

> First, a product may be found defective in design if the plaintiff establishes that the product failed to perform as safely as an ordinary consumer would expect when used in an intended or reasonably foreseeable manner. Second, a product may alternatively be found defective in design if the plaintiff demonstrates that the product's design proximately caused his injury and the defendant fails to establish, in light of the relevant factors, that, on balance, the benefits of the challenged design outweigh the risk of danger inherent in such design.[19]

Neither of the alternative tests—consumer safety expectations, or benefits outweigh risk of danger—suggests that additional liability should be imposed because the defendant has informed itself of the potential for harm of its product.

In fact, the second standard implies that one is expected to inform oneself, and it is this latter standard the *Grimshaw* court appears to have applied (though it says it did not), that the "benefits . . . outweigh the risk of danger." However, the court clearly believes that public safety always outweighs corporate profits.[20] That Ford weighed the cost that would be imposed by the design change and the benefit in saved lives and concluded that the benefit outweighed the cost, was "'conscious disregard' of the probability of injury to members of the consuming public."[21] One can search the opinion in vain for a suggestion that there was a numerical misevaluation, or that Ford failed to add in a relevant number. Rather, there is the presumption that the calculations were correct, and that that is *why* Ford should be punished.

The *Grimshaw* court was wrong on the law, and it was wrong as a matter of policy. But the outcome *may* not have been wrong as a matter of fact.

If we assume that people act rationally, then compensatory damages, fully compensatory damages, or adjusted compensatory

19. *Grimshaw*, 119 Cal. App. 3d at 801, 174 Cal. Rptr. at 376 (citing Barker v. Lull Eng'g Co., 20 Cal. 3d 413, 432, 573 P.2d 443, 455-56, 143 Cal. Rptr. 225, 237-38, (1978)).

20. *See supra* text accompanying note 14.

21. *Grimshaw*, 119 Cal. App. 3d at 813, 174 Cal. Rptr. at 382.

damages should be sufficient to generate efficient results.[22] But the markets that generate such results require information.

Information is itself a good that is costly to produce. Often "untrue" or "partially true" information has a greater value to the producer than does "true" information. There is, therefore, often an incentive to do that which is inefficient for the system as a whole. It may be argued that if by fraud or other artifice one can make a profit, that fraud is efficient (profits minus damages are greater than zero). But this ignores that the proper assessment of damages in order to assure that the move is Pareto superior requires knowledge of the true facts.[23] One must begin the analysis of efficiency somewhere,[24] and commonly we begin with something approaching a competitive market operating with something approaching full information.[25] Engaging in fraud, actively suppressing information, or actively misleading not only produces a need for compensation, it also undermines the foundation of the legal-economic structure in such a way that we cannot even guess the degree to which the system fails to operate efficiently.

Certain wrongs are efficient. In his article, Friedman reminds us that "[i]f the tortfeasor pays compensatory damages equal to the full cost imposed on the victim, he bears all the costs of his act and so makes the efficient decision."[26] Similarly, the theory of efficient breach in contract theory tells us that breach may be more socially desirable than performance.[27] But such conclusions presume the payment of compensation. Compensatory payment is required by the Pareto Superiority standard, that no one be made worse off and that at least one person be made better off, in the new state of society. (Absent compensation, torts and breaches of contract can be justified only on the far more questionable Kaldor-

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22. Subject to Friedman's elasticity adjustment in light of societal enforcement costs. *See supra* note 4.

23. For a discussion of the term "true facts" see See, *An Essay on Legal Ethics and the Search for Truth*, 3 GEO. J. LEGAL ETHICS, ____, ____ n.10 (1989).

24. Frank Knight, in THE ECONOMIC ORGANIZATION 9-10 (1951), makes clear that efficiency is a relative concept, not an absolute.

25. *See, e.g.*, Roberts, *Perfectly and Imperfectly Competitive Markets*, in 3 THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS 837, 838 (1987). Regrettably, there is as yet no satisfactory answer to the problem of second best, but in general we resolve not to "let the perfect be the enemy of the good," notwithstanding that theoretical problem.

26. Friedman, *supra* note 4, at 1126. His modification of this principle is the subject of his article.

27. *See* R. POSNER, ECONOMIC ANALYSIS OF LAW 105-114 (3d ed. 1986).

Hicks Potential Pareto Superiority standard that winners *could*, but do not, compensate losers.) Absent compensation, voluntary or enforced, tortious acts will not be Pareto efficient. It is also true that, due to enforcement costs, even with compensation available, the move from that state of society in which an injury has occurred, to one in which compensation has been paid, may not be efficient because of enforcement costs. This is Friedman's point. But, that possibility notwithstanding, compensation must be available if efficient behavior is to be induced.

Consider now the production of fraud and suppression. Fraud and suppression deny information necessary to efficient outcomes. Therefore, compensation is due. This we accomplish by operation of the legal system. But fraud and suppression do more than produce inefficient outcomes. They also deny the legal system what it needs in order to provide compensation. Efficiency is impossible because the basic information necessary for determining the proper level of compensation is unavailable.

Stephen Daniels reports in his American Bar Foundation study of punitive damages that in the various jurisdictions from zero to twenty-two percent of reported verdicts included punitive awards: "[P]unitive damages are not routine in the sites studied."[28] That is consistent with the analysis presented in this Article. Punitive awards should not be routine. Moreover, Daniels reports that "[c]ases in which false arrest or fraud are alleged are the most likely to have a punitive award."[29] False arrest implicates a different fundamental value—that of freedom—that I do not wish to treat here, but it is consistent with the foregoing that fraud should frequently generate punitive awards. On the other hand, we would expect medical malpractice, product liability, and other such claims seldom to result in punitive awards. Daniels found that "[a]reas like product liability and medical malpractice that figure so prominantly in the discussion of the civil justice crisis are not particularly large percentages of reported verdicts in any of the sites."[30]

These statistics suggest that a principled application of punitive damages only to cases that involve fraud, misrepresentation or

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28. S. Daniels, Punitive Damages: Storm on the Horizon? 11 (Preliminary report of the Punitive Damages Project, American Bar Foundation 1986).

29. *Id.* at 14.

30. *Id.*

suppression of information would not result in dramatic changes in gross statistics. I do not mean to suggest, however, that past cases can be explained on this rationale. For example, it is difficult to propose an explanation on this rationale of the relative frequency of punitive awards in personal injury cases. What I propose would be a change. It would not support punitive damages in some cases in which they are now awarded. But it would, in a principled and theoretically protected way, preserve them in areas in which they are common and perhaps even increase the frequency of their award in those areas.

When fraud, misrepresentation or suppression is discovered, it is deserving of punishment because it is anathema to the system. For the same reason, it should be deterred. And, if we are sure of the offense, we need not worry about overdeterrence. That term is undefined outside the legal-economic structure. An *economic* death sentence is justifiable because the very possibility of efficiency has been undermined.

Note, however, that punishment must *not* be for failure to generate costly information. Whether to invest in the creation of information is an appropriate economic decision; therefore, optimal resource allocation to the production of information should be induced. It is the investment in disinformation, or investment in active suppression of information, that justifies sanction.

On this rationale, it is important what Ford knew in the *Grimshaw* case. If Ford did not know the safety characteristics of the Pinto, then clearly it did not suppress or actively misinform the public. But that it knew is not alone sufficient to justify a punitive award. The further question must be asked whether Ford suppressed the safety information or misinformed the public on the matter of safety. This standard is similar to, and justified on the same rationale as, the imposition of punitive procedural measures if Ford actively attempted to thwart the compensation system by suppressing information from the court or by misinforming the court. We do not know whether Ford actively suppressed the safety information or misinformed the public. But, if it did, then the punitive damages imposed by the jury would be justifiable.