LITIGATION SERVICES HANDBOOK

The Role of the Financial Expert

Third Edition

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CHAPTER 13

PUNITIVE DAMAGES: AN ECONOMIC ANALYSIS*

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CONTENTS

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†Sections included in the original article that appeared in the *Harvard Law Review* but are omitted here.

The imposition of punitive damages is one of the more controversial features of the American legal system. Trial and appellate courts have struggled for many years to develop coherent principles for addressing the questions of when punitive damages should be awarded, and at what level. In this Article, Professors Polinsky and Shavell use economic reasoning to provide a relatively simple set of principles for answering these questions, given the goals of deterrence and punishment. With respect to the deterrence objective, on which their Article focuses, they argue that punitive damages ordinarily should be awarded if, and only if, an injurer has a significant chance of escaping liability for the harm he caused. When this condition holds, punitive damages are needed to offset the deterrence-diluting effect of the chance of escaping liability. (They mention as well a deterrence rationale for punitive damages that does not rest on the possibility of escape from liability—that punitive damages may be needed to deprive individuals of the socially illicit gains that they obtain from malicious acts.) Professors Polinsky and Shavell also discuss the tension between the implications of the deterrence objective and present punitive damages law, including the law's emphasis on the reprehensibility of a defendant's conduct and on a defendant's wealth. With respect to the punishment objective, Professors Polinsky and Shavell stress that the imposition of punitive damages on corporations may fail to serve its intended purpose (although the imposition of punitive damages on individual defendants accomplishes punishment in a straightforward manner). Punitive damages against corporations may be ineffective primarily because the payment of punitive damages awards by corporations often does not lead to greater punishment of culpable employees, but instead punishes the corporation's shareholders and customers.

13.1 INTRODUCTION. One of the more controversial features of the American legal system is the imposition of punitive damages. Courts have struggled for years to develop a rational set of principles for the imposition of punitive damages, legislative bodies have passed or considered a variety of statutes to remedy perceived problems with punitive damages, academic commentators have debated the theory behind, and significance of, punitive damages, and the press has expressed strongly divergent opinions about the merits of punitive damages.

Our goal in this Article is to develop a coherent and relatively simple set of principles for determining when punitive damages should be awarded and, in circumstances in which they are appropriate, what their level should be. We separately consider two social objectives: deterrence and punishment. Our methodology is economic in the sense that we organize our inquiry around an examination of how rational parties will respond to the threat of punitive damages, and whether their response will promote, or fail to promote, social welfare.

The analysis of the deterrence objective comprises the first and major part of the Article. Our conclusions in this part flow from the basic principle that, to achieve appropriate deterrence, injurers should be made to pay for the harm their conduct generates, not less, not more. If injurers pay less than for the harm they cause, underdeterrence may result—that is, precautions may be inadequate, product prices may be too low, and risk-producing activities may be excessive. Conversely, if injurers are made to pay more than for the harm they cause, wasteful precautions may be taken, product prices may be inappropriately high, and risky but socially beneficial activities may be undesirably curtailed.

It follows from these observations that a crucial question for consideration is whether injurers sometimes escape liability for harms for which they are responsi-

ble. If they do, the level of liability imposed on them when they *are* found liable needs to exceed compensatory damages so that, on average, they will pay for the harm that they cause. This excess liability can be labeled "punitive damages," and failure to impose it would result in inadequate deterrence. In summary, *punitive damages ordinarily should be awarded if, and only if, an injurer has a chance of escaping liability for the harm he causes.*

This principle often will have transparent implications for the circumstances in which punitive damages should be awarded in practice. Consider a company that is responsible for trucking toxic waste to a dump site where it will be charged disposal fees. To reduce its fees, suppose the company allows some of the waste to leak onto the highway, because it knows that the leak is unlikely to be noticed and traced to its source. Under our analysis, punitive damages obviously would be called for because of the significant chance that the company will escape liability for the harm it caused. Alternatively, suppose the gross negligence of the firm that is responsible for treating the waste at the dump site leads to a substantial and highly visible spill from the firm's waste storage tanks. Punitive damages would not be appropriate because the firm is unlikely to escape detection and liability for this harm.

When an injurer has a chance of escaping liability, the proper level of *total damages* to impose on him, if he is found liable, is the harm caused multiplied by the reciprocal of the probability of being found liable. Thus, for example, if the harm is $100,000 and there is a 25 percent chance that the injurer will be found liable for the harm for which he is legally responsible, the harm should be multiplied by 1/.25, or 4, so total damages should be $400,000. Because the injurer will pay this amount every fourth time he generates harm, his average payment will be $100,000 (= $400,000/4). Thus, on average, the injurer will pay for the harm he causes, and appropriate deterrence will result. Once the proper level of total damages is calculated in this way, punitive damages can be determined by subtracting compensatory damages from the total. In the example, because compensatory damages would equal the harm of $100,000, punitive damages would equal $300,000 (= $400,000 − $100,000).

If punitive damages are needed according to this theory, we believe that courts and juries often will be able to obtain enough information about the likelihood of escaping liability to apply the theory reasonably well. We will discuss how our analysis relates to several leading punitive damages cases, and we will provide model jury instructions that can be used to aid jurors in applying the principles that we develop.

We also will relate our analysis of the deterrence rationale for punitive damages to the criteria commonly applied by courts in imposing such damages. Importantly, we will explain that the reprehensibility of a corporate defendant's conduct generally should not be a factor in deciding whether, and to what extent, to impose punitive damages for purposes of promoting deterrence (although the reprehensibility of the conduct of a person who is a defendant may be relevant to punitive damages and deterrence). In addition, we will argue that the wealth of a corporate defendant presumptively should not be taken into account in determining the level of punitive damages (although again the conclusion may be different in the case of a person who is a defendant). We also will consider other aspects of punitive damages policy from the perspective of deterrence, including the appropriateness of

caps on punitive damages, the relevance of potential harm for punitive damages, the insurability of punitive damages, and the importance for punitive damages of the distinction between victims who are customers of an injurer and victims who are strangers to the injurer.

One further observation about our analysis of deterrence is worth noting. We ordinarily assume that the benefits that injurers derive from engaging in the conduct that gives rise to harm is included in the calculation of social welfare. We also will discuss, however, the possibility that such benefits should not be included—notably, when a wrongdoer derives pleasure from his victim's suffering. We will explain that, if the injurer's benefits are excluded from social welfare, punitive damages may be needed for proper deterrence even when there is no chance of escaping liability.

In our discussion of the second objective of punitive damages—punishment—we focus on the assumption that the underlying goal of society is to penalize especially blameworthy *individuals*. Achieving this goal is reasonably straightforward if the defendant is a person who has been found to have acted culpably—after all, imposing punitive damages on that person punishes him. But if the defendant is a corporation, imposing punitive damages on it may or may not lead to the punishment of blameworthy individuals within the corporation, for a variety of reasons that we will discuss. To the extent that such individuals are not punished, imposing punitive damages on the corporation does not advance the punishment goal. Moreover, we will explain that much of the sting from imposing punitive damages on corporations may be borne by individuals who are usually not thought to be culpable, namely, shareholders and customers. In the light of these points, we conclude that the extent to which imposing punitive damages promotes the punishment goal may be significantly different when defendants are corporations from when they are individuals, and that the importance of punitive damages as a form of punishment may be considerably attenuated for corporate defendants.

The plan of our Article is as follows. In Part II, we review the economic theory of deterrence and develop the basic principles determining when punitive damages should be awarded, and at what level. We also apply these principles to certain aspects of punitive damages law and legislation, as well as to several prominent punitive damages cases. Part III relates the basic principles to a number of criteria that are employed by the courts to determine the appropriateness and magnitude of punitive damages awards, and also examines a variety of other factors and policies that bear on punitive damages. Part IV discusses the punishment goal of punitive damages. Part V briefly summarizes our main points. An Appendix contains the model jury instructions for use in awarding punitive damages.

13.2 DETERRENCE: THE BASIC THEORY. In this Part, we summarize the basic principles of the economic theory of deterrence and explain what these principles imply for the use of punitive damages. By deterrence, we mean what is often called *general deterrence*, namely, the effect that the prospect of having to pay damages will have on the behavior of similarly situated parties in the future (not just on the behavior of the defendant at hand).

We should add that the basic theory that we are about to review is the standard theory of deterrence, on which economically oriented scholars widely agree. As

noted, we will usually make the conventional assumption that the benefits that injurers obtain from engaging in the conduct that gives rise to harm are credited in social welfare. Thus, for example, we will assume that the time saved by a speeding driver, or the cost saved by a company that chooses not to purchase certain pollution control equipment, constitutes a social benefit that is to be weighed against the harm from speeding or polluting. We will consider the implications for punitive damages of the alternative assumption—that the benefits from harmful conduct do not count in social welfare—when we examine the reprehensibility criterion in Section III.A.

We first discuss deterrence in a very simple setting in which a party will be sanctioned whenever he causes harm. We then discuss the situation in which parties sometimes escape sanctions for harms for which they are responsible. It is in this latter case, as we indicated above, that damages exceeding harm should be imposed, and punitive damages thus used.

(a) Optimal Damages When the Defendant Is Found Liable with Certainty

. . .

(b) Optimal Damages When the Defendant Can Sometimes Escape Liability. The main point that we will develop in this section is that *if a defendant can sometimes escape liability for the harm for which he is responsible, the proper magnitude of damages is the harm the defendant has caused, multiplied by a factor reflecting the probability of his escaping liability.* As we will explain, use of such a multiplier will make defendants pay on average for harm actually done and thus will lead to socially desirable behavior in terms of precautions and participation in risky activities.

There are several reasons that injurers sometimes escape liability for harms for which they should be liable. First, the victim may have difficulty determining that the harm was the result of some party's act—as opposed to simply being the result of nature, of bad luck. For instance, an individual may develop a form of cancer that could have been caused by exposure to a naturally occurring carcinogen, such as radon gas, but which was in fact caused by exposure to a manmade carcinogen that was released by the injurer.

Second, even if the victim knows that he was injured by some party's conduct, he may have difficulty proving who caused the harm. The owner of a parked car that was damaged might know that it had been struck by another vehicle, but not be able to identify the injurer. Those living near a polluted lake might know both that pollution is responsible for an unusually high rate of disease in their neighborhood and who the polluters are, but not be able to establish causation in court.

Third, even if the victim knows both that he was wrongfully injured and who injured him, he might not sue the injurer. A person will tend not to bring a suit if the legal cost and the value of the time and effort he would have to devote to the suit exceed the expected gain. The decision to forgo suit will often occur when the harm the victim has suffered is relatively small or the likelihood of establishing causation is low. (Additionally, a victim might not sue if he has a distaste for the legal process.)

For one or more of the above reasons, injurers will sometimes be able to escape liability for harms for which they should be held responsible. The consequences of this possibility are clear: *if damages merely equal harm, injurers' incentives to take precautions*

will be inadequate and their incentive to participate in risky activities will be excessive. Suppose that there is only a one-in-four chance that an injurer will be found liable for a $100,000 harm, for which he would have to pay damages of $100,000. On average, then, the injurer will pay $25,000 when he causes the harm—only a fraction of the harm caused. If the harm could have been prevented each time by taking a $50,000 precaution, the injurer will not have an adequate incentive to take the precaution, because the precaution cost will exceed his average liability cost by a substantial margin. Moreover, because the injurer will pay only $25,000 on average for a $100,000 harm, he will engage in the risky activity to an excessive degree. If the injurer is a firm, the price of its product will rise by an amount reflecting only one-quarter of the harm caused, leading consumers of the product to buy more of it, and thereby cause more harm, than is socially desirable.

To remedy these problems of underdeterrence, damages that are imposed in those instances in which injurers are found liable should be raised sufficiently so that injurers' average damages will equal the harm they cause. In the example in the preceding paragraph, in which the chance of being found liable for having caused a $100,000 harm is only one in four, damages should be raised to $400,000. Then, on average, the injurer will pay $100,000 when he causes the harm—on average, every four times he causes harm, he will be found liable once for $400,000. Equivalently, his total damages will tend to equal the total amount of harm that he has caused. As we emphasized above, making injurers liable for the harm they cause will induce them to take proper precautions and participate appropriately in risky activities.

This discussion suggests a simple formula for assuring that injurers will pay for the harms they cause: *the total damages imposed on an injurer should equal the harm multiplied by the reciprocal of the probability that the injurer will be found liable when he ought to be.* We will refer to this multiplier as the *total damages multiplier.* In the example in the preceding paragraph, the probability that the injurer would be found liable was one in four, or .25; thus, the multiplier is 1/.25, or 4. Because the harm was $100,000, this formula will result in total damages imposed on the injurer of $400,000. Similarly, if the injurer would be found liable with a one-in-two chance, damages should be $200,000—the $100,000 harm multiplied by 2 (=1/.5). And if the chance of liability is only one in ten, damages should be $1,000,000—the $100,000 harm multiplied by 10 (=1/.1). The application of this formula will guarantee that, on average, injurers will pay for the harm they cause, and therefore take proper precautions and appropriately participate in risky activities.

It is important to stress that the level of damages given by the formula is optimal not only because this level remedies problems of underdeterrence, but also because it avoids problems of overdeterrence. The latter problems, described above, would arise if damages were to exceed the optimal amount.

We will refer to the excess of total damages over compensatory damages as *punitive damages.* Thus, the *optimal* level of punitive damages from the perspective of deterrence is the level of total damages determined by the formula, less compensatory damages. If an injurer has a one-in-four chance of being found liable for causing a $100,000 harm, the formula implies that total damages should be $400,000. Because $100,000 of this total represents compensatory damages, the $300,000 remainder is the optimal amount of punitive damages.

The optimal level of punitive damages also can be described as a multiple of harm or, equivalently, a multiple of compensatory damages. Specifically, punitive dam-

ages should equal the harm multiplied by a factor that we will refer to as the *punitive damages multiplier:* the ratio of the injurer's chance of escaping liability to his chance of being found liable. In the example in the previous paragraph, the injurer has a three-in-four chance of escaping liability and a one-in-four chance of being found liable. The punitive damages multiplier is therefore .75/.25, or 3. Because the harm was $100,000, punitive damages should be three times this amount, or $300,000.

Although we refer to the excess of total damages over compensatory damages as punitive damages, the adjective "punitive" may sometimes be misleading. This is because extracompensatory damages may be needed for deterrence purposes in circumstances in which the behavior of the defendant would not call for *punishment.* As we have explained, the deterrence goal leads us to impose such damages when injurers may escape liability. But injurers might escape liability even when their conduct is not strongly blameworthy. Suppose an injurer accidentally (perhaps even non-negligently) causes harm, but the victim does not sue, either because he is unable to trace the harm to its source or because of the cost of litigation. In other words, nonblameworthy conduct might still call for punitive damages to achieve proper deterrence. Despite a certain inappropriateness, therefore, in using the label "punitive damages" to refer to extracompensatory damages needed for deterrence reasons, we will continue to employ it because it is the common term for extracompensatory damages in private civil litigation.

We have several comments to make about the punitive damages formula presented in this section. First, judges and juries often will be able to apply the formula without difficulty because the formula transparently (if trivially) implies that no punitive damages are needed. In other words, in many situations, it will be obvious that the injurer has virtually no chance of escaping liability—say because the harm occurred openly and the magnitude of the harm is such that the victims almost surely will bring suit. Examples of such situations are when a building collapses as a result of a plainly defective design and when a supertanker runs aground and spills a large quantity of oil on the shoreline, where the oil is observed by many people. In such cases, the proper total damages multiplier is one—that is, total damages should equal harm. Punitive damages are not needed for proper deterrence, and imposing them would result in the problems of overdeterrence discussed above.

. . .

Fifth, an important question about the multiplier formula arises in cases in which the defendant is a firm: Should the damages multiplier be based on the probability that the firm will be found liable, or on the generally lower likelihood that the responsible employee will be found liable? The answer is that the firm's probability is the relevant one. Consider a situation in which a firm definitely would be found liable for a harm resulting, say, from an explosion of a chemical storage tank, but the employee whose actions led to the explosion might be difficult to identify. Because the firm will have to pay for the harm for sure, punitive damages are not needed: The firm's product price and its incentives to take precautions will be correct because it will be paying for all of the harm it causes if it pays just compensatory damages. That the particular employee who caused the explosion might not be caught does not alter this point—the employee's escaping responsibility does not free the firm from liability. Were the firm to face punitive damages because of the employee's chance of escaping liability, overdeterrence would result.

. . .

(c) Consistency of Punitive Damages Law with the Basic Theory of Deterrence. We now will relate our analysis to certain important aspects of legal doctrine concerning punitive damages, and also to legislation imposing caps on punitive damages.

As noted above, one of the two main purposes of punitive damages is deterrence. The courts state, for example, that punitive damages are intended "to deter the wrongdoer and others from committing similar wrongs in the future." Given that achieving proper deterrence is an avowed goal of courts, *it follows from the logic of deterrence theory that courts should take the punitive damages formula presented above into explicit account.* Otherwise, courts cannot responsibly weigh the proper punitive damages amount for achieving deterrence against the proper amount for achieving the other main purpose of punitive damages, punishment.

However, courts' determinations of punitive damages do not reflect in any clear manner the formula that achieves optimal deterrence. Although courts do consider the magnitude of harm in assessing the proper level of punitive damages, they do not use harm as the base to be multiplied by an appropriate damages multiplier. Rather, courts take harm into account in a vague way, through application of the general principle that punitive damages should bear a "reasonable relationship" to compensatory damages. They do not explain what this relationship should be and, even when they identify a ratio of punitive damages to compensatory damages that they find excessive, they do not supply a basis for selecting the particular ratio identified.

As the reader knows, our analysis implies a simple and precise relationship between punitive damages and harm: Punitive damages should equal the harm multiplied by what we refer to as the punitive damages multiplier. If punitive damages are to achieve appropriate deterrence, the "reasonable relationship" criterion must be interpreted in this specific way. Any other relationship between punitive damages and compensatory damages will lead to either inadequate or excessive deterrence.

Courts also do not pay systematic attention to the probability of escaping liability, even though this probability is the central element in determining the appropriate damages multiplier for the purpose of achieving proper deterrence. Courts sometimes allude to the possibility of escaping liability, but they rarely recognize its importance with respect to deterrence. For example, in determining the level of punitive damages, courts occasionally consider whether the defendant has attempted to conceal his conduct. Courts usually do so, however, in assessing the reprehensibility of the defendant's conduct; they generally do not appreciate that evidence of attempted concealment should influence the calculation of the defendant's chance of escaping liability. Additionally, courts sometimes mention that the cost of litigation should be taken into account "so as to encourage plaintiffs to bring wrongdoers to trial." This factor is obviously related to the injurer's chance of escaping liability because one reason an injurer might not be found liable is that he is not sued. Thus, courts occasionally refer to considerations that bear on the probability that a defendant would have escaped liability. But they rarely explain in a direct and systematic way how this probability should be used to determine the proper level of damages for deterrence purposes.

Further, courts generally pay insufficient attention to the potential problem of overdeterrence. Judicial opinions mention this issue only infrequently, and none of the lists of factors used by courts in determining punitive damages includes overde-

terrence as a consideration. As we have emphasized, however, damages that exceed the level indicated by the formula may result in wasteful precautions and the withdrawal of socially valuable products and services from the marketplace.

Not only do courts usually fail to consider correctly the factors that are relevant to proper deterrence, but they also err in considering a variety of factors that generally *are not* relevant to deterrence, including the reprehensibility of defendants' conduct and defendants' wealth. We will discuss at some length why these factors ordinarily should not be taken into account if the goal is to promote proper deterrence, but the point we want to make here is that consideration of these factors in awarding punitive damages causes such damages to deviate further from the level given by our formula.

Some aspects of legislation governing punitive damages are also inconsistent with deterrence theory. Notably, many states have imposed caps of various kinds on punitive damages awards: an absolute ceiling (for example, $350,000 in Virginia), a maximum ratio of punitive damages to compensatory damages (for example, three times compensatory damages in Florida), or both. Such caps cannot be justified on deterrence grounds because they might preclude the proper award of punitive damages. For example, suppose that the harm caused by an injurer is $100,000 and that he has only a one-in-ten chance of being found liable. The optimal level of punitive damages is then $900,000, or nine times compensatory damages (because the optimal level of total damages, including compensatory damages, is ten times the harm). This absolute amount and this ratio would exceed punitive damages caps in the majority of states that have them, yet under the circumstances posited, a punitive damages award of this magnitude, and that has this relationship to compensatory damages, is needed for proper deterrence.

Our criticism of caps is not meant to deny that, if jury awards of punitive damages are thought to be systematically excessive, caps might beneficially constrain such awards. But in the absence of systematic bias, caps are inappropriate.

(d) Punitive Damages Cases. We briefly consider here three prominent punitive damages cases in the light of the deterrence principles discussed above. Our primary objective is to state what deterrence theory suggests about the appropriate level of punitive damages in these cases, given their facts and circumstances, not to analyze the legal doctrines that were applied or developed in them.

1. *BMW of North America, Inc. v. Gore.*—In this case, the plaintiff, Ira Gore, Jr., purchased a new BMW sedan from an Alabama dealer. He subsequently learned that the defendant, BMW of North America, had repainted part of the car because of damage to the car before its arrival in the United States, although BMW had not disclosed this fact. The jury awarded Gore compensatory damages of $4000 for diminution in the value of the car, and punitive damages of $4 million. The Alabama Supreme Court reduced the punitive award to $2 million, but the U.S. Supreme Court held even this award to be grossly excessive. On reconsideration, the Alabama Supreme Court reduced the punitive award to $50,000.

Consider the probability that BMW would escape liability for having sold a repainted car as new. The determination of this probability involves two factors. One is the possibility that BMW would escape notice for having repainted a car, and the other is the likelihood that a purchaser who did discover that his car had

been repainted would sue. Gore drove the car for nine months without detecting any abnormalities in the paint on his car. It was only after he took his car to a detail shop that he learned that it had been repainted. It seems reasonable to suppose, therefore, that many purchasers of repainted cars sold as new would never discover that their cars had been repainted.

Whether an owner who did discover that his car had been repainted would sue depends on the costs to him of suit (time and out-of-pocket expense) and the amount that he could collect. If the harm is as low as the jury found in *Gore*, $4,000, it would seem that many owners—or the lawyers they might hire on a contingency fee—would not have a sufficient financial incentive to sue. There may have been a significant chance, therefore, that BMW would have escaped liability if damages were merely compensatory, because of victims' inadequate motive to sue.

In *Gore*, information that would be useful in estimating the probability of BMW's being found liable was provided. Among the facts established at trial were that 14 new BMW cars in Alabama had been repainted, including Gore's, and one prior suit had been brought against BMW by an owner of one of these cars. If none of the other Alabama victims of repainting were to sue, the probability of detection and liability might be thought to be 2 in 14, in which case the total damages should be seven times the $4,000 harm, or $28,000. Of that total, $4,000 would represent compensatory damages, and $24,000 would represent punitive damages. By this reasoning, the $2 million punitive award initially approved by the Alabama Supreme Court was grossly excessive, and the reduced award of $50,000 was much more reasonable.

2. *Pacific Mutual Life Insurance Co. v. Haslip.*—This case involved an insurance agent who misappropriated premium payments. The insurance policy in question was a group health plan sold to the municipality of Roosevelt City, Alabama. When Cleopatra Haslip, a city employee, was hospitalized, she apparently did not know that the policy had lapsed because of the agent's misappropriation. When the hospital and her physician sought payment from her, she and other Roosevelt City employees sued the agent and the Pacific Mutual Life Insurance Company for fraud. The jury awarded her total damages of $1,040,000, of which $200,000 appears to have been assessed as compensatory damages and $840,000 as punitive damages. The award was affirmed by the trial court, the Alabama Supreme Court, and the U.S. Supreme Court.

The key issue relating to deterrence in this case is whether a significant chance exists that an insurance company whose agent misappropriates premiums will escape liability for coverage that individuals expected to have. (The focus should be on the company's chance of escaping liability, rather than the agent's, for the reason we explained above.) Obviously, if a policy has been invalidated because of an agent's misappropriation of premium payments, the invalidation will come to the attention of a person who applies for coverage under that policy. If the insurance company does not pay the individual voluntarily, the individual probably would sue the company, provided the amount at stake is large enough.

In the present case, the compensatory damages were, as noted, $200,000. However, less than $4,000 of this amount represented out-of-pocket expenditures, the rest apparently consisting of non-economic losses such as emotional distress. It seems reasonable to suppose that recovery of the $4,000 out-of-pocket loss is more probable than recovery of the $196,000 non-economic loss. If the likelihood of the

latter recovery is sufficiently low, an individual probably would not bring a lawsuit. Conversely, if this likelihood is high, a lawsuit would be much more certain. A related consideration is that three other Roosevelt City employees joined Haslip in suing the defendants. Their awards totaled approximately $38,000. Clearly, the prospect of obtaining this additional amount would increase the incentive to sue. On balance, therefore, although a suit seems reasonably likely in the circumstances of *Haslip,* some countervailing considerations might justify a modest punitive damages award, to offset the chance that a lawsuit would not be brought.

3. *In re The Exxon Valdez.*—In this case, the defendant's supertanker, the *Exxon Valdez,* ran aground on a reef in Prince William Sound in Alaska, spilling 11 million gallons of oil and polluting over 1,000 miles of Alaskan coastline. The supertanker's captain, Joseph Hazelwood, had previously been treated for alcohol abuse and, in connection with the accident at issue, was found to have violated regulations governing alcohol consumption. In the private civil litigation against Exxon stemming from the accident, the plaintiffs—various classes of fishermen and Alaskan natives—were awarded several hundred million dollars in compensatory damages and $5 billion in punitive damages. The punitive damages award was affirmed by the trial judge and is being appealed.

It seems clear that in the circumstances of the *Exxon Valdez* accident, there was essentially no chance that the defendant company, Exxon Corporation, could escape liability. An accident of this magnitude obviously would have been noticed. Moreover, because the tanker was stuck on a reef, the identity of the injurer was plain. And given the substantial compensatory damages involved, in the hundreds of millions of dollars, a lawsuit certainly could be expected. Thus, according to our analysis, no punitive damages are needed, or appropriate, in the circumstances of this case because the injurer could not have escaped liability for compensatory damages. (In other contexts involving oil spills—such as the intentional dumping of small amounts of waste oil that is unlikely to be detected or traced to the spiller—some punitive damages would be appropriate.)

13.3 DETERRENCE: EXTENSIONS OF THE BASIC THEORY. In this Part, we will discuss several important doctrinal and policy issues in punitive damages law from the perspective of the deterrence principles developed above. Most of these topics (such as the reprehensibility of the defendant's conduct) have received substantial attention in judicial opinions, others (whether the state should receive a portion of a punitive damages award) have been considered primarily in a legislative context, and still others (the status of the plaintiff as a customer or a third party) apparently have not been addressed in either setting.

(a) Reprehensibility of Conduct. The law requires that a defendant be found to have acted in a reprehensible manner—in a way that is egregious, malicious, or undertaken with reckless disregard for the rights of others—before punitive damages can be imposed on him. If a defendant is found to have so acted, the degree of his reprehensibility is often treated as a key factor in determining the level of punitive damages. Indeed, the United States Supreme Court in *Gore* observed that this factor is "[p]erhaps [the] most important" indicium of the reasonableness of a punitive damages award. The reprehensibility of the defendant's conduct was also one of the factors listed by the Court in *Haslip.*

Should reprehensibility per se affect the imposition of punitive damages, given the goal of deterrence? In this section, we explain that it generally should not. However, an important exception to this conclusion occurs when injurers' gains do not count in social welfare, which we believe is often the case when injurers act maliciously. This exception, we will suggest, only possibly applies to individual defendants, and not to corporate defendants.

As discussed above, under standard assumptions, the imposition of damages equal to harm, appropriately multiplied to reflect the probability of escaping liability, achieves proper deterrence. That a defendant's conduct can be described as reprehensible is in itself irrelevant. Rather, the focus in determining punitive damages should be on the injurer's chance of escaping liability.

Making punitive damages depend on reprehensibility will distort deterrence in two ways. First, excessive damages may be imposed when reprehensible conduct occurs in situations in which an injurer is virtually certain to be found liable. Suppose that a surgeon, through extreme negligence, fails to remove a surgical tool from the body of a patient and that this omission leads to great pain and suffering. If a high probability exists that the surgeon will be sued and found liable because of the magnitude of the patient's harm and the unmistakable error of the surgeon, extracompensatory damages are neither necessary nor appropriate. Similarly, consider a newspaper reporter who, out of reckless disregard for the truth, confuses one firm's safe product with another firm's dangerous product, substantially damaging the former firm's business reputation and profitability. Here, too, we might expect that suit and a finding of liability would be very likely, in which case extracompensatory damages would be excessive. Thus, *even for conduct that is reprehensible,* if little chance of escaping liability exists, compensatory damages alone will achieve appropriate deterrence, and punitive damages will result in overdeterrence.

One might wonder, though, how overdeterrence of reprehensible acts can occur, because society evidently has an interest in deterring such acts completely. To illustrate that overdeterrence still can occur, consider the example of the surgeon. If the magnitude of damages is very high, we can imagine that, to reduce the chance of leaving a surgical tool in a patient, he might hire another medical professional to monitor his actions or he might dramatically increase the time he spends on each operation. Even if such responses would succeed in preventing the recurrence of this event, they may be at too great a cost, especially if the likelihood of leaving a surgical tool in a patient is very low anyway. In other words, it might not be socially worthwhile for the surgeon to take the measures needed to eliminate the possibility of his being extremely negligent. Yet a level of liability in excess of that given by the damages formula would improperly encourage him to take these measures.

The problem of overdeterrence also can arise in connection with the reprehensible acts of employees of corporations. Employees obviously cannot be controlled perfectly by a corporation, even though a corporation can improve its ability to prevent employees from committing reprehensible acts by screening them before hiring them and monitoring their conduct afterwards. If damages exceed the level determined by the damages formula, however, the corporations may be led to spend excessively on screening and monitoring efforts in order to forestall reprehensible behavior. This might be true of a newspaper, for instance, if it faced punitive damages for false reporting because of extreme negligence, as in our example

of the reporter who confused two firms' products. In response, the newspaper might assign two reporters to every story even if doing so is not socially worthwhile given the cost of this practice and the reduction in risk of reprehensible behavior that would be accomplished.

Not only can attention to reprehensibility result in the imposition of punitive damages that are excessive, but such attention may also lead to the converse problem: the failure to employ punitive damages when they are needed for proper deterrence. This problem will occur if an individual engages in conduct that is harmful, though *not* reprehensible, and he is likely to escape liability. Suppose that a toxic waste disposal truck develops a leak (say, from rust) that results in waste spilling onto a highway at night, when no one is likely to notice it. The driver of the truck may have performed a proper inspection before departing, and the company may have reasonable maintenance policies. Although the leak is not caused by anyone's reprehensible behavior, substantial extracompensatory damages may be appropriate if the leak is discovered, to offset the significant likelihood that the injurer would not be identified and held responsible for the harm.

It is clear from the foregoing discussion that the stress courts place on reprehensibility of conduct in considering punitive damages cannot be justified on grounds of deterrence. A minor qualification of this point is that, as we observed earlier, courts treat attempts by the defendant to conceal wrongdoing as a factor that enhances reprehensibility, and thus the level of punitive damages. This response makes rough sense because such behavior clearly reduces the probability of liability. But, as suggested above, the link that courts make between this behavior and punitive damages is vague in nature. We believe that it would be preferable to use evidence of concealment directly to aid in the determination of the chance that the defendant might have escaped liability, rather than as a factor in determining reprehensibility.

Finally, although the reprehensibility of a defendant's conduct should not be used per se as a basis for imposing punitive damages to achieve proper deterrence, such conduct may sometimes provide useful information about the defendant's chance of escaping liability. Everything else being equal, the lower the chance of being found liable, the lower will be an individual's level of care. Therefore, a low care level may suggest a low probability of liability and thus a higher level of punitive damages according to our formula.

Let us now turn to the important exception to our general conclusion about reprehensibility, which, as noted above, arises if injurers' gains are not counted in social welfare. Suppose that a person, out of spite, punches another individual; his purpose is to cause harm to the victim. Society might well treat the pleasure the injurer obtains from this act as *socially illicit,* not to be counted in social welfare. If so, the act should be deterred completely because it produces no social gain, only harm. To achieve this goal, damages must exceed the injurer's utility from committing the act. Because the injurer's illicit utility could be greater than the harm suffered by the victim, the level of damages needed for proper deterrence might be in excess of harm. In other words, punitive damages might be socially desirable even if there is no chance that the injurer could have escaped liability.

When are the benefits from harmful conduct likely to be considered socially illicit? We suggest that benefits tend to be treated as illicit when the injurer's utility derives from causing harm itself, as when a person punches another out of spite or

defames another to see him suffer. The injurer benefits *because* the victim suffers harm. Situations with this characteristic fit under the general rubric of maliciousness and would be considered reprehensible. Thus, *some reprehensible conduct—malicious conduct—could give rise to gains that are not counted in social welfare, in which case punitive damages may be justified even in the absence of a chance of escaping liability,* for the reasons discussed in the previous paragraph.

But many acts that are reprehensible do not seem to be associated with socially illicit utility; they are not undertaken with malice. Consider a person who drives at 60 miles per hour through a residential area in order to arrive at work on time and causes a fatal accident. We would call this act reprehensible because of the driver's wanton disregard for the safety of others. Yet because the purpose of the act is not to cause harm, but rather to arrive at work on time, a perfectly legitimate objective, it does not appear that the utility from the act would be classified as socially illicit. In general, we surmise that reprehensible acts that are not undertaken with the objective of causing harm, but rather that happen to cause it as a highly likely by-product, usually are not associated with socially illicit utility. Thus, for these kinds of acts, punitive damages should not be imposed unless the injurer has a significant chance of escaping liability—our usual conclusion.

Note that because the goal of corporations is to make a profit, rather than to cause harm to others, their gains presumably do count in social welfare. Hence, by the foregoing reasoning, if a corporation engages in conduct labeled as reprehensible, this fact per se should not affect the level of its damages. Rather, its damages should be based on the harm it caused and the chance that it might have escaped liability, with punitive damages awarded only if the latter chance is significant.

In summary, we believe that the reprehensibility of a defendant's conduct generally should not be taken into account for the purpose of determining optimal damages for deterrence. The notable exception to this conclusion occurs when the defendant is an individual whose conduct is motivated by malice and whose gains consequently are not included in social welfare.

(b) Wealth of Defendants. The courts often state that a defendant's financial condition is a relevant factor in setting a punitive damages award, with the understanding that higher punitive damages may be appropriate for defendants with higher wealth. Jury instructions also frequently include the defendant's wealth as a factor that jurors may take into account in determining the level of punitive damages. Not surprisingly, plaintiffs tend to emphasize this factor when defendants are wealthy, especially when the defendants are large corporations.

Should defendants with greater wealth pay higher punitive damages? Our main conclusion in this section is that, from the perspective of achieving proper deterrence, a defendant's wealth generally should not be considered when the defendant is a corporation. We also conclude that the wealth criterion frequently should not be considered when the defendant is an individual, although we discuss certain circumstances in which an individual's wealth should be taken into account in imposing punitive damages.

We explained above that, if damages equal harm multiplied by a factor reflecting the chance of escaping liability, defendants, including corporations, would be induced to take optimal precautions and to participate in risky activities to the proper extent. It follows from this basic conclusion that, if damages are raised above the

magnitude given by our formula when corporations are relatively wealthy, those corporations will be led to take excessive precautions, will undesirably curtail their activities, and will set prices above the proper level, chilling consumption of their products. In an extreme case, such corporations might even withdraw their products from the marketplace despite the value of the products to society.

An additional point reinforces the conclusion that corporate wealth should not influence punitive damages: Imposing punitive damages on the basis of corporate wealth effectively imposes a tax on corporate size and success, thereby discouraging growth and development. This effect can be important in industries in which liability costs are a significant component of total cost (such as in the pharmaceutical and general aviation aircraft industries). Of course, retarding the natural growth of corporations can have adverse consequences, notably, that society forgoes economies of scale in production and in research and development. It also may mean that the risk of harm increases, because small firms may not have enough at stake to make it worthwhile to them to spend a socially proper amount on precautions.

Our discussion of the inappropriateness of taking corporate wealth into account presumes that all corporations—large and small—will, if required to pay for the harms they cause, tend to balance correctly the costs of precautions against the resulting reduction in harm. An argument sometimes is made, however, that because bigger corporations are more bureaucratic, they will not adequately respond to liability risks unless the damages imposed on them are especially high. According to this argument, higher damages are needed against large corporations to attract the attention of senior management. This view is mistaken, as we now discuss.

Although large corporations typically have complicated organizational structures, with senior management at some remove from the level of operations, it does not follow that large corporations will tend to be insufficiently attentive to the reduction of risk. If the cost of a precaution is less than the damages incurred by not taking it, a large firm will want someone employed by it to recognize that fact and take the precaution—because the firm's goal is to maximize profits. A large grocery chain, for example, will want some employee at each of its stores to inspect that store's floor after it is mopped in order to ensure that it is safe. The company will delegate this responsibility to an employee low in the corporate hierarchy, such as an assistant store manager. That this task does not receive the attention of top management, as it might in the case of a firm consisting of only one or two grocery stores, does not mean that the task will be neglected or attended to inadequately. As long as a corporation—large or small—expects to have to pay for the harms it causes, it will have a socially appropriate incentive to reduce the harms.

Now consider the question of the relevance of wealth for the imposition of punitive damages on individuals. Again, the general arguments we made above imply that punitive damages should not depend on an individual's wealth; rather, punitive damages should depend only on the level of harm and the chance of escaping liability, so that, applying the damages multiplier formula, expected damages equal harm. However, two qualifications to this conclusion suggest that wealth might be relevant in certain circumstances.

The first concerns risk aversion and the unavailability of insurance against punitive damages. We noted above that if potential injurers are risk averse and do not have access to liability insurance, appropriate deterrence will be accomplished

with a lower level of damages than if they are risk neutral. Further, the more risk averse an individual is, the lower the optimal level of damages. Assuming that poor individuals are more risk averse than rich ones, the optimal level of punitive damages will be lower for poorer individuals. Equivalently, punitive damages should be higher for wealthier individuals. However, even for the wealthiest individuals, punitive damages should not exceed the level determined by our formula. The relevance of these observations, we reiterate, is limited to situations in which insurance against punitive damages is not available.

The second circumstance in which the level of an individual's wealth may be relevant to the calculation of punitive damages is when the individual's gain from committing the harmful act is socially illicit. We explained above that punitive damages may be needed to offset illicit benefits. To accomplish this, punitive damages generally will have to rise with the wealth of an individual, because the value of money tends to decline with wealth. For example, to offset the utility a rich person would obtain from slandering someone he disliked, we might need to impose $10,000 in punitive damages, whereas to deter a person with only modest assets, $1,000 in punitive damages might suffice.

We believe that the foregoing point underlies the common intuition that punitive damages should be linked to wealth. However, this point has a very limited scope, applying only to individuals whose benefit from causing harm is socially illicit, which we generally associate with conduct whose goal is to cause harm. Otherwise, the point of the previous paragraph does not apply to individuals. Moreover, the point does not apply to firms because firms are motivated by profits, rather than by a desire to cause harm.

(c) Potential Harm

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(d) Gain of Defendants

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(e) Litigation Costs

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(f) Related Private Litigation

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(g) Related Public Penalties

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(h) Tax Treatment of Punitive Damages

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(i) Insurability of Punitive Damages

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(j) Third Party versus Consumer Victims. Our analysis of punitive damages has assumed implicitly that the parties harmed by the injurer are "third parties"—that is,

parties who have no market or contractual relationship with the defendant. Such was the case, for example, with respect to the fishermen and Alaskan natives whose livelihood was affected by the *Exxon Valdez* oil spill. In many situations, however, the victims are customers of the defendant, as in *Gore,* in which the plaintiff was a purchaser of a car made by the defendant.

When determining punitive damages, courts devote little attention to whether the plaintiff was a third party or a consumer. The list of factors in *Haslip,* for example, does not include this distinction, nor does any other similar list or authoritative source of which we are aware.

However, the status of victims as third parties or consumers is important to consider, for when victims are consumers, the need for punitive damages is lessened. The reason is that, when individuals might be harmed by the products (or services) they buy, producers will tend to be concerned that customers may not be willing to pay as much for the products or that they may stop purchasing the products altogether. Given that producers have this market-based incentive to be attentive to the risk of harm to their customers, the need for liability in general, and for punitive damages in particular, to control their behavior is diminished. Obviously, this market mechanism cannot operate if the victims are not customers of the defendant—that is, if they are third parties.

The extent to which market forces reduce the need for liability as a deterrent depends on how much customers know about product or service hazards. In some circumstances, customers will not be able to discipline firms effectively because of their lack of knowledge of such risks. Because travelers probably would not know much about the chance of suffering food poisoning from eating at a family-owned restaurant at a turnpike stop, the restaurant would not be likely to fear loss of clientele if food poisoning were to occur. Thus, the threat of liability, including punitive damages, might be desirable to induce the restaurant to reduce this risk.

In many settings, however, consumer information about the dangers of products and services is relatively good. This may be because the risks have a fairly obvious character, because they have been publicized by the media, or because the customers are repeat purchasers and have learned about them from experience. In such circumstances, the threat of liability would be relatively unimportant in controlling risk. Indeed, if consumer information about risk were perfect, liability to improve product safety would be unnecessary: Consumers would reduce their willingness to pay for a firm's product or service by precisely the amount of the expected harm to which the product or service exposed them, which in turn would cause firms to invest in any cost-justified precautions.

Our conclusion, therefore, is that in deciding on punitive damages, courts should take into account whether the victims are third parties or customers and, if the latter, whether market forces are likely to lead sellers to reduce risk properly. A skeptical approach to imposing punitive damages should be adopted when consumers are relatively well-informed about the risk of the seller's product or service.

(k) Breach of Contract

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(l) Components of Harm Not Included in Compensatory Damages

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(m) Economic Loss versus Personal Injury

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(n) Externalization of Risk through Independent Contractors

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(o) Encouraging Market Transactions

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13.4 PUNISHMENT. By the punishment objective we refer to society's goal of imposing appropriate sanctions on blameworthy parties. We equate blameworthiness with the reprehensibility of a party's conduct, that is, with its maliciousness or the extent to which it reflects disregard for the well-being of others. We assume that the punishment objective derives ultimately from the pleasure or satisfaction people obtain from seeing blameworthy parties punished (although our essential conclusions do not depend on this assumption).

When the defendant is an individual, the connection between the imposition of punitive damages and the accomplishment of the punishment objective is conceptually straightforward: if, after assessing the blameworthiness of an individual's act, appropriate punitive damages are levied, the punishment objective is achieved.

However, when the defendant is a firm, the relationship between punitive damages and the punishment objective is more complex. In this regard, we will develop three points. The first is that there are different ways of viewing the objective of punishment: the goal may be to punish firms as *entities,* that is, independently of whether blameworthy individuals within the firms are penalized; or the goal may be to punish firms only as a means of punishing culpable *individuals* in the firms. Our second point is that the imposition of punitive damages on firms may not lead to the punishment of blameworthy individuals within them; thus, the goal of punishing blameworthy employees may not be well promoted by imposing punitive damages on firms. The final point is that the imposition of punitive damages on firms often penalizes individuals who are unlikely to be considered culpable, namely, shareholders and customers. We conclude that, to the extent that the goal is to punish culpable individuals within firms, and not firms as entities, the utility of punitive damages in achieving the punishment objective is significantly attenuated.

Consider the possibility that the punishment objective might be furthered because people obtain satisfaction directly from the punishment of a blameworthy firm as an organization, without regard to whether anyone within the firm behaved inappropriately or is punished. We find this conception of the punishment goal unappealing both because it requires a definition of blameworthiness of a firm that is divorced from the behavior of any individuals who are affiliated with it, and because it necessitates believing that people would, after reflecting on the matter, want to impose a penalty on what ultimately is an artificial legal construct. The notion that individuals would want to punish firms per se strikes us as not entirely different from the idea that individuals would want to punish inanimate objects for causing harm (such as trees that fall on people).

Notwithstanding these reservations, it is possible that individuals do want to personify firms and punish them as entities, and the reader can make up his or her

mind about the importance of this way of defining the punishment objective. To the extent that it is important, the imposition of punitive damages on a blameworthy firm directly promotes the punishment objective, much as it does when the defendant is a culpable individual.

Now consider the alternative reason for punishing firms—to punish blameworthy individuals within them. Supposing that this is the purpose of punishment, we turn to our second point, about the extent to which the imposition of punitive damages on firms will actually result in the punishment of blameworthy employees. Because firms clearly have an interest in discouraging culpable conduct by their employees that could give rise to punitive damages, they can be expected to seek to control such conduct through the use of internal sanctions, such as demotion or dismissal. However, two considerations suggest that the imposition of punitive damages on firms will lead to less punishment of blameworthy employees than might at first be supposed.

First, culpable employees may not be punished by firms because the firms may have difficulty identifying them. Such individuals may be able to obfuscate their role in decision making or conceal their behavior in a variety of ways. For example, an employee responsible for checking a safety valve on a tank storing dangerous chemicals that subsequently explodes because of a defective valve may claim that he performed the inspection even if he did not, and may place a false entry in his record book attesting to the inspection. A manager whose judgment is impaired by alcohol and who gives oral instructions to a subordinate that lead to an accident may deny ever having told the subordinate to do what the subordinate did.

Second, even if culpable individuals within a firm can be identified and punished by the firm, imposing punitive damages on firms often will have little or no *marginal effect* on their punishment. That is, the internal sanction imposed on such employees may not be much (if at all) greater as a result of the firm's bearing both punitive and compensatory damages than if the firm had borne compensatory damages alone. When a firm incurs high compensatory damages because of the blameworthy conduct of an identifiable employee, it may want to levy whatever sanctions on him that it can; imposing punitive damages on the firm then would not result in additional punishment of the employee.

The preceding discussion presupposed that there exist culpable employees in the firm. But in some situations there may not be any. If a significant delay occurs between misconduct and the manifestation of harm and litigation (as was the case, for instance, in connection with the use of asbestos in products), blameworthy individuals may have changed jobs, retired, or died. Also, because decisions in firms often are made by many individuals, it may be that no one individual has the requisite knowledge of risk and of the consequences of his behavior to be considered culpable. One person may decide to put a toxic liquid in a storage tank, believing that the tank can never leak, and another person may leave the tank in a state in which a leak can occur, thinking that the liquid in the tank is not toxic, so that a leak would not cause harm. Here, each decision considered by itself may not be blameworthy because each person believes that what he is doing does not create a risk of a harmful accident.

Let us now consider the third point, concerning how imposing punitive damages on firms often penalizes the firms' shareholders and customers. Shareholders, as residual claimants of a firm's profits, obviously will be made worse off when

punitive damages are levied on a firm. Indeed, they usually can be expected to bear a major fraction of the burden of punitive damages. Given that shareholders are punished by punitive damages, the question whether they are blameworthy must be considered. If a shareholder owns a significant fraction of a firm's stock, participated actively in the firm's decisions, and acted egregiously, his position would be much like that of a blameworthy employee with decision-making power; each would be culpable. But if a shareholder owns a minuscule fraction of the stock of the firm and was a passive investor with no direct involvement in the firm's decision-making processes, his degree of blameworthiness would be small, if not nonexistent.

A firm's customers also will be made worse off as a result of the imposition of punitive damages on the firm if such damages cause the prices of the firm's products or services to rise. Firms may regard punitive damages as an additional cost of doing business—a cost that, with a positive probability, will be borne by them in addition to their ordinary costs. To cover the added cost of punitive damages, firms will tend to raise their prices, which will cause the welfare of their customers to decline. Customers, however, would not ordinarily be considered blameworthy, because they do not exert direct control over the actions of firms that pose risks to other persons. Consequently, to the extent that customers pay higher prices as a result of the imposition of punitive damages on firms, innocent parties are penalized.

We can summarize our discussion of the punishment of firms as follows. The view that a firm should be punished per se—without reference to the punishment of individuals within it—is a possible view, but one that we find problematic. Another view is that the punishment goal is promoted only by punishing blameworthy individuals within firms. We have explained, however, that imposing punitive damages on firms often will not result in the punishment (or at least any additional punishment) of blameworthy employees, so the use of such damages might not advance the punishment goal very much. Moreover, imposing punitive damages frequently will penalize shareholders and customers, parties who are not likely to be considered blameworthy. This adverse consequence of punitive damages must be weighed against the beneficial effects of such damages in furthering the punishment goal.

Having addressed punitive damages and punishment in general terms, we now briefly consider how the reprehensibility of the defendant's conduct and the wealth of the defendant should influence punitive damages with respect to the punishment objective. Regarding reprehensibility, we merely observe that the punishment objective will, by definition, be met if sanctions are imposed on those who have acted reprehensibly. Hence, determining the reprehensibility of the defendant's conduct is intrinsic to satisfaction of the punishment objective, and the law's focus on reprehensibility obviously makes sense given this objective. In the case of firms, however, the connection between reprehensibility and punishment may be attenuated for reasons discussed above—the imposition of punitive damages on a firm may not result in the punishment of individuals within the firm who acted reprehensibly.

Concerning defendants' wealth and the appropriate level of damages from the perspective of punishment, consider first the situation when defendants are individuals. In this case, the common belief that punitive damages should be higher for wealthier defendants can be justified. The punishment goal is furthered if a proper

punishment is imposed on a culpable individual, which we interpret to mean reducing the individual's utility by a particular amount. To accomplish this, it is generally necessary to assess a higher penalty if the individual is wealthy than if he is poor, because money is worth less to him if he is wealthy.

When the defendant is a firm, the relevance of the defendant's wealth depends on whether the punishment goal is viewed in terms of punishing the firm as an entity or punishing culpable individuals within the firm. Under the first view, the firm's wealth might be thought to be relevant to the proper level of damages for punishment purposes. Under the second view, however, the firm's wealth generally would not be relevant: The level of damages needed to induce a firm to punish its culpable employees ordinarily would not depend on its wealth. A $100 million firm and a $10 million firm would both be expected to impose the same sanction on an employee for misconduct that resulted in a punitive damages award of a given amount. The reason is that, as we have said, rational firms will develop a policy of punishing employee misbehavior to lower their liability expenses. This policy should depend on variables other than the firm's wealth—notably, the damages that the firm will bear as a result of employee misbehavior. To the extent that the internal sanctions that firms impose on culpable employees do not depend on the firm's wealth, the punishment objective will not be advanced by making punitive damages depend on its wealth.

13.5 CONCLUSION. In this Article, we have discussed the two fundamental purposes of punitive damages—deterrence and punishment—and have come to conclusions regarding each objective that we now briefly review.

Our central conclusion about punitive damages and deterrence is conceptually simple. Punitive damages should be imposed when deterrence otherwise would be inadequate because of the possibility that injurers would escape liability. In particular, punitive damages should be set at a level such that the expected damages of defendants equal the harm they have caused, for then their damage payments will, in an average sense, equal the harm. This implies a simple formula for calculating punitive damages, according to which harm is multiplied by a factor reflecting the likelihood of escaping liability. If punitive damages are calculated according to this multiplier formula, precautions will tend to be optimal—neither inadequate nor excessive—as will product prices and the incentive to participate in risky activities. These conclusions about punitive damages, and the importance of the role of the defendant's chance of escaping liability, flow from the standard and well-accepted theory of deterrence. We also discussed a deterrence rationale for punitive damages that is not based on the possibility of escaping liability: that punitive damages may be needed to offset the socially illicit utility that individuals obtain from committing malicious acts. This rationale, as we noted, does not apply to firms.

The theory of deterrence not only yields a multiplier formula for computing punitive damages, but also provides guidance regarding a range of important doctrinal and policy issues concerning punitive damages. Notably, we discussed the point that the reprehensibility of a party's conduct generally should not be a factor in the assessment of punitive damages (except in the case of an individual's malicious act), as well as the point that the wealth of a defendant usually should not influence punitive damages (subject to the same exception).

A corollary of our analysis is that the imposition of punitive damages when they are not justified on deterrence grounds generally has socially detrimental consequences. These consequences can take the form of excessive precautionary measures and inappropriate discouragement of participation in socially beneficial activities. In the case of firms, the latter effect may manifest itself in the form of undesirably high prices and the withdrawal of products from markets.

With respect to the punishment objective, we observed that the connection between punitive damages and punishment is relatively straightforward if the defendant is an individual, or if the defendant is a firm and the goal is to punish firms as entities (although we found this latter goal problematic). We came to a different conclusion, however, when the defendant is a firm and the objective is to punish culpable employees. Because the imposition of punitive damages on firms may not result in the punishment of blameworthy employees, but often will penalize shareholders and customers—parties who are not likely to be blameworthy—the ability of punitive damages to advance the punishment goal in the case of firms is limited.

We have not yet commented on how the level of punitive damages should be determined when the objectives of deterrence and punishment have different implications for the proper measure of punitive damages. It is evident that the best level of punitive damages should be a compromise between the levels that are optimal when each objective is considered independently. (The quantities of punitive damages that are separately optimal with respect to the two objectives should not be added to each other.) The weights to be used in the determination of the compromise will reflect the relative importance accorded to the goals of deterrence and punishment.

Whatever are the weights that policymakers, judges, or juries place on these two goals, we hope that the conceptual framework developed in this Article will aid them in determining the appropriate amount of punitive damages.

APPENDIX: Model Jury Instructions

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