ECONOMIC GUIDLINES FOR AWARDING EXEMPLARY DAMAGES

MICHAEL J LEGG*

Australian and American law both recognise that where exemplary damages are available their purpose is deterrence and punishment. In the United States the goal of exemplary damages and the effectiveness of the legal system in achieving that goal have been the subject of extensive research. The idea of exemplary damages being imposed to punish or seek retribution against an individual for a gratuitous moral wrong has been questioned due to the prevalence of the corporate form. In the case of corporate wrongdoing economic theory has been invoked to argue that the focus of exemplary damages should be optimal deterrence. According to the economic analysis of deterrence, the socially correct or optimal level of deterrence is created by compelling the responsible party to internalise the full social cost of its conduct, but nothing more than that. It further follows that the financial circumstances of a corporate defendant are irrelevant. In trying to give effect to the economics of deterrence, there has been research into the decision-making processes of jurors which concluded that placing the exemplary damages decision in the discretion of jurors leads to arbitrary awards. Accordingly, this article seeks to draw on the economics of deterrence and cognitive psychology research to provide guidance to Australian courts faced with a claim for exemplary damages.

I INTRODUCTION

Australian and American law both recognise that where exemplary damages (referred to as punitive damages in the United States) are available[1] their goal or purpose is deterrence and punishment.[2] However, while exemplary damages have been relatively rare and of modest size in Australia they have reached

* Solicitor, Gilbert + Tobin Lawyers; member of the New York Bar.

1 The specific causes of action for which exemplary damages may be sought vary on a State by State basis with legislative enactments curtailing their availability in certain circumstances. For example, *Civil Liability Act 2002* (NSW) s 21 forbids exemplary damages in relation to personal injury arising from negligence but s 3B specifies exceptions to the Act such as 'an intentional act that is done with intent to cause injury or death or that is sexual assault or other sexual misconduct', claims for damages for dust diseases and injury or death resulting from smoking or use of tobacco products.

2 For a more detailed comparison of Australian and US punitive damages law see John Y Gotanda, 'Punitive Damages: A Comparative Analysis' (2004) 42 *Columbia Journal of Transnational Law* 391. The issue of exemplary damages has also been recently examined under English law, *Kuddus v Chief Constable of Leicestershire Constabulary* [2002] 2 AC 122 and New Zealand law, *A v Bottrill* [2003] 1 AC 449 (Privy Council).

immense proportions in the United States.[3] The size of American exemplary damages awards has led to research in two important fields, the 'economics of deterrence' so as to provide a framework for assessing the necessity and size of exemplary damages, and the cognitive limitations of jury members that impact on jury decision-making. Both fields have received renewed prominence due to the US Supreme Court decision in *State Farm Mutual Auto Ins Co v Campbell*[4] which recognised the utility of the economics of deterrence and the dangers of vague jury instructions in achieving the goal of exemplary damages.

In Australia, exemplary damages are a discretionary remedy for which little guidance is provided.[5] Due to the lower visibility of exemplary damages there has been less research undertaken in Australia than in the US. Consequently, this article seeks to draw on the economics of deterrence and cognitive psychology research to provide guidance for Australian courts faced with a claim for exemplary damages.

II AUSTRALIAN EXEMPLARY DAMAGES LAW

Exemplary damages have a long history in English law that was adopted by courts in Australia.[6] Australian courts have repeatedly defined the purpose of exemplary damages as being punishment and deterrence. For example: 'exemplary damages have been considered ... to be punitive for reprehensible conduct and as a deterrent';[7] 'exemplary damages are awarded ... to punish and deter';[8] 'exemplary damages ... are intended to punish the defendant, and presumably to serve one or more of the objects of punishment – moral retribution or deterrence';[9] 'the jury ... expresses in its verdict its view of the seriousness of the defendant's behaviour, and its decision to deter any repetition by a punitive award';[10] 'Exemplary damages are not awarded to compensate the plaintiff but to punish and deter the wrongdoer';[11] '[exemplary damages are] awarded to punish the wrongdoer and deter others from like conduct'.[12]

3 See Richard L Blatt et al, *Punitive Damages: A State-by-State Guide to Law and Practice* § 1.4 (2004) finding that in 2001 there were 16 punitive damages awards in excess of $100 million. The highest award of punitive damages in US history as at the date of publication was a $145 billion award made to a class of smokers and former smokers in *Engle v RJ Reynolds Tobacco*, (Fla Cir Ct, 6 November 2000) (NO 94-08273 CA-22), overturned on appeal *Liggett Group Inc v Engle* 853 So 2d 434 (Fla Dist Ct App 3d 2003).

4 538 US 408 (2003) ('*Campbell*').

5 *Gray v Motor Accident Commission* (1998) 196 CLR 1, 10-12.

6 *Whitfeld v De Lauret & Co Ltd* (1920) 29 CLR 71, 81 where Isaacs J traced the history of exemplary damages in English law and *Uren v John Fairfax & Sons Pty Ltd* (1966) 117 CLR 118, 138-9 where Taylor J cites the adoption of the principle in Australian High Court cases. See also *Gray v Motor Accident Commission* (1998) 196 CLR 1, 5.

7 *Whitfeld v De Lauret & Co Ltd* (1920) 29 CLR 71, 81.

8 *Uren v John Fairfax & Sons Pty Ltd* (1966) 117 CLR 118, 130 (Taylor J), citing *Rookes v Barnard* [1964] AC 1129, 1221.

9 *Uren v John Fairfax & Sons Pty Ltd* (1966) 117 CLR 118, 149 (Windeyer J).

10 *XL Petroleum (NSW) Pty Ltd v Caltex Oil (Australia) Pty Ltd* (1985) 155 CLR 448, 465 (Murphy J).

11 Ibid 470 (Brennan J).

12 *Gray v Motor Accident Commission* (1998) 196 CLR 1, 7 (Gleeson CJ, McHugh, Gummow and Hayne JJ).

Australian law has also sought to balance a judge's or jury's discretion to punish or deter where warranted with the need to avoid additional damages based on 'mere disapproval of the conduct of a defendant.'[13] As a result there must be something more than a tort for which damages are permissible, leading to the requirement that there be a 'conscious wrongdoing in contumelious disregard of another's rights.'[14] Australian law therefore requires some form of conscious or intentional conduct, which does not ordinarily arise in claims based on negligence.[15]

The High Court has also found that a jury is entitled to consider the financial circumstances of a defendant and link the amount of exemplary damages awarded to those circumstances.[16] A jury may also consider the likelihood of repeat conduct and 'assess exemplary damages in an amount that would be likely to have a deterrent effect – sufficient to make [the defendant] smart.'[17] Financial circumstances and deterrence have been tied together to allow a jury to determine 'what sum will be a sufficient deterrent.'[18] The exemplary damages award need not be proportional to the amount of compensatory damages,[19] but the jury may be told to consider the amount of compensatory damages awarded and whether that amount inflicts adequate punishment on the defendant in deciding whether to award exemplary damages.[20] However, the High Court has also emphasised that the conduct of the wrongdoer is the central inquiry in determining whether an award of exemplary damages is warranted.[21]

The High Court has also held that where substantial punishment has been inflicted on the defendant through the criminal law for substantially the same conduct, exemplary damages are not warranted.[22] This is because the purposes for the awarding of exemplary damages, punishment and deterrence, have been wholly met if substantial punishment is exacted by the criminal law.[23] Such a finding is also supported by the practice or rule of law that a person should not be punished twice for what is the same act.[24]

13 *Uren v John Fairfax & Sons Pty Ltd* (1966) 117 CLR 118, 153 (Windeyer J).

14 Ibid 154. *Gray v Motor Accident Commission* (1998) 196 CLR 1, 6: 'Exemplary damages are awarded rarely. They recognise and punish fault, but not every finding of fault warrants their award. Something more must be found.'

15 *Gray v Motor Accident Commission* (1998) 196 CLR 1, 9-10 (Gleeson CJ, McHugh, Gummow and Hayne JJ) and 28 (Kirby J). The High Court gave an example of exemplary damages being awarded in a negligence action by referring to an employer failing to provide a safe system of work when it knew of an extreme danger, such as in *Midalco Pty Ltd v Rabenalt* [1989] VR 461.

16 *XL Petroleum (NSW) Pty Ltd v Caltex Oil (Australia) Pty Ltd* (1985) 155 CLR 448, 461 (Gibbs CJ), 464 (Murphy J).

17 Ibid 472 (Brennan J). See also *Harris v Digital Pulse Pty Limited* (2003) 56 NSWLR 298, 345-6 (Heydon JA).

18 *XL Petroleum (NSW) Pty Ltd v Caltex Oil (Australia) Pty Ltd* (1985) 155 CLR 448, 472 (Brennan J) and *Gray v Motor Accident Commission* (1998) 196 CLR 1, 143 (Callinan J), listing a number of relevant factors, including 'the means of the defendant [and] the deterrent effect upon the defendant'.

19 *XL Petroleum (NSW) Pty Ltd v Caltex Oil (Australia) Pty Ltd* (1985) 155 CLR 448, 471 (Brennan J).

20 *Backwell v AAA* (1997) 1 VR 182, 206-9.

21 *Gray v Motor Accident Commission* (1998) 196 CLR 1, 12.

22 Ibid 14.

23 Ibid. The Court has not elaborated on how substantial the punishment would need to be or how similar the acts in the two proceedings would have to be for the above reasoning to apply.

24 Ibid.

Australia prohibits excessive awards of damages. In general, an award of exemplary damages is excessive if no reasonable jury could have arrived at the number or the award is out of all proportion to the circumstances of the case.[25]

III American Punitive Damages Law

The purpose of punitive damages in the United States is to achieve deterrence and retribution.[26] However, the standard for awarding punitive damages varies across the 50 States from malice, to conduct exceeding gross negligence, to gross negligence.[27] The amount of a punitive damages award is also circumscribed by the US Constitution. The Due Process Clause of the Fifth and Fourteenth Amendments prohibits the imposition of grossly excessive or arbitrary punishments on a tortfeasor.[28] In *Campbell*, Justice Kennedy explained the reason for the prohibition as follows:

> Elementary notions of fairness enshrined in our constitutional jurisprudence dictate that a person receive fair notice not only of the conduct that will subject him to punishment, but also of the severity of the penalty that a State may impose.[29]
>
> To the extent an award is grossly excessive, it furthers no legitimate purpose and constitutes an arbitrary deprivation of property.[30]

25 *Coyne v Citizen Finance Ltd* (1991) 172 CLR 211, 238.

26 *State Farm v Campbell*, 538 US 408, 416 (2003). See also *BMW of North America Inc v Gore*, 517 US 559, 568 (1996): 'Punitive damages may properly be imposed to further a State's legitimate interests in punishing unlawful conduct and deterring its repetition'; *Pacific Mutual Life Ins Co v Haslip*, 499 US 1, 19 (1991): 'punitive damages are imposed for purposes of retribution and deterrence'.

27 Blatt et al, above n 3, § 3.2. For example in California, a plaintiff may recover punitive damages only where it is proven by clear and convincing evidence that the defendant has been guilty of oppression, fraud, or malice: *California Civil Code* § 3294(a). In New York the conduct must have a high degree of moral culpability which manifests a 'conscious disregard of the rights of others or conduct so reckless as to amount to such disregard.' Such conduct need not be intentionally harmful but may consist of actions which constitute wilful or wanton negligence or recklessness: *Home Ins Co v American Home Products Corp*, 550 NE 2d 930, 934 (1990).

28 *State Farm v Campbell*, 538 US 408, 416 (2003); *Cooper Industries Inc. v Leatherman Tool Group Inc*, 532 US 424, 433 (2001); *BMW of North America Inc v Gore*, 517 US 559, 562 and 587 (1996) (Breyer J concurring), '[t]his constitutional concern, itself harkening back to the Magna Carta, arises out of the basic unfairness of depriving citizens of life, liberty, or property, through the application, not of law and legal processes, but of arbitrary coercion'. A punitive damage award that is imposed arbitrarily violates procedural due process while a grossly excessive award violates substantive due process. However, substantive and procedural due process will frequently overlap as a person will not have been given notice (a fundamental procedural due process right) of an excessive award violating substantive due process, and excessive awards are frequently arbitrary.

29 *State Farm v Campbell*, 538 US 408, 417 (2003) citing *Cooper Industries Inc. v Leatherman Tool Group Inc*, 532 US 424, 433 (2001); *BMW of North America Inc v Gore*, 517 US 559, 574 (1996). The need for due process protections in the award of punitive damages arises because punitive damages determinations serve the same purposes as criminal penalties, but defendants are not accorded the protections applicable to a criminal proceeding, such as double jeopardy. See *United States v Halper*, 490 US 435, 451 (1989): 'The protections of the Double Jeopardy Clause are not triggered by litigation between private parties'.

30 *State Farm v Campbell*, 538 US 408, 417 (2003). *Pacific Mutual v Haslip*, 499 US 1, 42 (1991) (O'Connor J dissenting).

To ensure punitive damages awards were consistent with due process the US Supreme Court in *BMW of North America Inc v Gore*[31] instructed courts reviewing punitive damages to consider three guideposts: (1) the degree of reprehensibility of the defendant's misconduct; (2) the disparity between the actual or potential harm suffered by the plaintiff and the punitive damages award; and (3) the difference between the punitive damages awarded by the jury and the civil penalties authorised or imposed in comparable cases.[32]

In *Gore* the Supreme Court stated that 'the most important indicium of the reasonableness of a punitive damages award is the degree of reprehensibility of the defendant's conduct.'[33] In *Campbell* the Court went on to instruct trial courts to consider whether the harm caused was physical as opposed to economic, the tortious conduct evinced an indifference to or a reckless disregard of the health or safety of others, the target of the conduct had financial vulnerability, the conduct involved repeated actions or was an isolated incident and the harm was the result of intentional malice, trickery, or deceit, or mere accident.[34]

The Supreme Court's jurisprudence has a long history of adopting a requirement of proportionality between the offence or harm inflicted and any punitive damages award.[35] More recently the Supreme Court has given guidance on proportionality by referring to the ratio between compensatory and punitive damages. The Supreme Court has advised trial courts that an award of more than four times the amount of compensatory damages might be close to the line of constitutional impropriety, and that historically only sanctions of double, treble and quadruple damages were used.[36] However, there may be exceptions to the general rule, such as when particularly egregious conduct results in a small amount of compensatory damages thus warranting a greater ratio.[37]

Lastly, an appellate court must consider what civil penalties would be available for the same conduct as substantial deference should be paid to legislative judgments about appropriate sanctions.[38] The civil penalties provide another indicator for measuring the reasonableness of the punitive damages award.

31 517 US 559 (1996) ('*Gore*').
32 Ibid 575.
33 Ibid.
34 *State Farm v Campbell*, 538 US 408, 419 (2003). See also *BMW of North America Inc v Gore*, 517 US 559, 576-7 (1996) which referred to the first, second and fifth of these factors.
35 See *BMW of North America Inc v Gore*, 517 US 559, 575 (1996) citing *Day v Woodworth*, 54 US 363, 371 (1852), asserting that punitive damage awards should reflect a relationship to 'the enormity of [the defendant's] offense'; *St Louis IM & SR Co v Williams*, 251 US 63, 66-7 (1919), instructing that punitive damages may not be 'wholly disproportioned to the offense'.
36 *State Farm v Campbell*, 538 US 408, 425 (2003); *Pacific Mutual Life Ins Co v Haslip*, 499 US 1, 23-4 (1991).
37 *State Farm v Campbell*, 538 US 408, 425 (2003).
38 Ibid 428; *BMW of North America Inc v Gore*, 517 US 559, 583 (1996).

IV The Economics of Deterrence

A *Deterrence and Corporations*

In the United States, the traditional idea of exemplary damages being imposed to punish or seek retribution against an individual for a gratuitous moral wrong has been questioned due to the prevalence of the corporate form and because 'the punished misconduct that characterizes the contemporary debate more frequently is profit-driven and entails calculated business risks at least colorably associated with production of goods or services having some social utility.'[39] The rational profit maximising role of corporations means that they will react to any costs that impact their competitive position,[40] because those firms that create consumer value have the best long-run prospects for survival.[41] The optimal level of deterrence therefore most accurately balances the need to deter with avoiding over-deterrence.[42]

According to the economic analysis of deterrence, the socially correct or optimal level of deterrence is created by compelling the responsible party to internalise the full social cost of its conduct, but nothing more than that.[43] If a firm's business decision leads to harm to its consumers and correspondingly increases costs, the firm's competitive position will decline. As a firm seeks to maximise profits it is then given an incentive to redress those costs through safer or more ethical operations to increase profitability. Complete compensatory damages will usually be sufficient alone to inform the firm as to those features of its product or service where further development of safety may be appropriate.[44] Exemplary damages will only be necessitated if the compensatory damages do not establish a sufficient level of deterrence.

39 *TVT Records v Island Def Jam Music Group*, 279 F Supp 2d 413, 421 (SDNY 2003). See also Kenneth S Abraham and John Calvin Jeffries Jr, 'Punitive Damages and the Rule of Law: The Role of Defendant's Wealth' (1989) 18 *Journal of Legal Studies* 415, 418-19.

40 Milton Friedman, *Capitalism and Freedom* (1962) 133, 'making maximum profits for stockholders'; Frank H Easterbrook and Daniel R Fischel, *The Economic Structure of Corporate Law* (1991) 12, stating that shareholders have implicitly contracted for a promise that firm will maximise profits in long run.

41 Michael E DeBow and Dwight R Lee, 'Shareholders, Nonshareholders, and Corporate Law: Communitarianism and Resource Allocation' (1993) 18 *Delaware Journal of Corporate Law* 393, 418.

42 Optimal deterrence is not the only model of deterrence, but it is the one supported by economic analysis because it reflects the need to avoid over-deterrence and the need to take account of the probability of detection. The other models of deterrence are general deterrence which relies on the prospect of paying damages generally to dissuade the defendant and other similarly situated parties from engaging in harmful conduct, and complete deterrence which aims to ensure that the defendant and others refrain entirely from committing similar harms in the future regardless of the costs/benefits of the activity to society. See Dan B Dobbs, 'Ending Punishment in "Punitive" Damages: Deterrence-Measured Remedies' (1989) 40 *Alabama Law Review* 831, 857; Thomas B Colby, 'Beyond the Multiple Punishment Problem: Punitive Damages as Punishment for Individual, Private Wrongs' (2003) 87 *Minnesota Law Review* 583, 610; A Mitchell Polinsky and Steven Shavell, 'Punitive Damages: An Economic Analysis' (1998) 111 *Harvard Law Review* 869, 877.

43 Steven Shavell, *Economic Analysis of Accident Law* (1987); William M Landes and Richard A Posner, *The Economic Structure of Tort Law* (1987); Polinsky and Shavell, above n 42, 878-80; Colby, above n 42, 609.

44 George L Priest, 'Punitive Damages Reform: The Case of Alabama' (1996) 56 *Louisiana Law Review* 825, 830-1; W Kip Viscusi, 'Punitive Damages: The Social Costs of Punitive Damages Against Corporations in Environmental and Safety Torts' (1998) 87 *Georgetown Law Journal* 285.

The US Supreme Court in *Campbell* adopted this reasoning. Compensatory damages are intended to redress the concrete loss that the plaintiff has suffered by reason of the defendant's wrongful conduct, while exemplary damages serve the function of achieving deterrence and punishment.[45] The *Campbell* decision held that:

> It should be presumed a plaintiff has been made whole for his injuries by compensatory damages, so punitive damages should only be awarded if the defendant's culpability, after having paid compensatory damages, is so reprehensible as to warrant the imposition of further sanctions to achieve punishment or deterrence.[46]
>
> ...
>
> The compensatory damages for the injury suffered here, moreover, likely were based on a component which was duplicated in the punitive award. Much of the distress was caused by the outrage and humiliation the Campbells suffered at the actions of their insurer; and it is a major role of punitive damages to condemn such conduct. Compensatory damages, however, already contain this punitive element.[47]

Therefore, no exemplary damages are warranted from a deterrence perspective if compensatory damages are alone sufficient to deter.

Additional exemplary damages amounts are only necessary if there is a significant chance that the responsible defendant will escape full liability for its wrongful conduct or similarly situated corporations having committed the same wrong can evade detection.[48] For example, exemplary damages may be necessary where the injuries that are suffered are concealed or difficult to detect, such as in a price fixing action where consumers will have no independent judgment as to the level of the competitive price and so will not detect every time that they are overcharged. Similarly, where the harm can be detected but the identity of the defendant is unknown, as in the context of surreptitious dumping of a toxic substance, exemplary damages may be justified in order to make the anticipated liability equal to the full societal costs of such harmful acts. In short, the size of damages should vary inversely with the probability that a defendant's wrongdoing will be detected.[49] If the chance of detection is 50 per cent then the total penalty must be twice the value of the harm.

[45] *State Farm v Campbell*, 538 US 408, 416 (2003). See also Restatement (Second) of Torts § 903 (1979). Australian law also recognises this distinction between compensatory and exemplary damages: *Uren v John Fairfax & Sons Pty Ltd* (1966) 117 CLR 118, 138 (Taylor J).

[46] *State Farm v Campbell*, 538 US 408, 419 (2003).

[47] Ibid 426. See also *TVT Records v Island Def Jam Music Group*, 279 F Supp 2d 413, 424 (SDNY 2003), 'a full compensatory award not only places upon the defendant the obligation to make the victim whole; it also superimposes substantial additional costs'.

[48] Polinsky and Shavell, above n 42, 887-96; David Crump, 'Evidence, Economics, and Ethics: What Information Should Jurors Be Given to Determine the Amount of a Punitive-Damage Award?' (1998) 57 *Maryland Law Review* 174, 192.

[49] Catherine M Sharkey, 'Punitive Damages: Should Juries Decide?' (2003) 82 *Texas Law Review* 381, 389.

Equally, the welfare of society is harmed whenever damages awards are significantly excessive.[50] When damages awards are excessive, product and service prices increase.[51] In some contexts, excessive damages awards encourage those affected to invest in unnecessary measures to reduce exposure, such as excessive investments in defensive medicine which increase health care costs without a corresponding benefit. Excessive awards also create disincentives to innovation and cause socially useful products and services, such as child vaccines,[52] to be withdrawn from markets to the detriment of consumers. Excessive damages awards thus divert resources from other worthwhile societal goals.

The above economic theory may be illustrated by a simple example. Assume that a car without an airbag costs $30 000 and an airbag costs $5 000 and a person is injured by the car without an airbag. If the injury is greater than $5 000 then it makes sense for the airbag to be added to the car because the harm is greater than the cost of the precaution. Optimal deterrence aims to ensure that damages equal harm so that a correct economic decision is reached. The role of compensatory and exemplary damages can be illustrated if two different levels of compensatory damages are assumed – $10 000 and $1 000. In the first example the car manufacturer will clearly incur the $5 000 cost of the airbag to prevent future injuries without any exemplary damages. In the second example the car manufacturer would not add airbags. To induce a change in this policy an exemplary damages award of $4 001 would be necessary. However, if $1 000 is the compensatory damages and also reflects the actual harm, that is, it makes the plaintiff whole, then exemplary damages may result in socially excessive precautions. An award of greater than $4 000 in exemplary damages would result in airbags being installed even though they cost more than the harm they prevent. The key to optimal deterrence working well is knowledge about the cost of the harm and of the precaution. To then take account of the likelihood of detection a second step must be taken. Assume that the harm caused is $10 000 but the chance of detection is 25 per cent or a one in four chance. Although there will be four accidents giving rise to $40 000 harm the car manufacturer will only be held liable once to pay $10 000. To take account of this, in the instance when liability is found then the total penalty must be four times the value of the harm, $40 000, to provide optimal deterrence. Accurate information about the likelihood of detection is necessary for optimal deterrence to succeed.

50 See, eg, *BMW of North America Inc v Gore*, 517 US 559, 593 (1996): 'Larger damages would 'over-deter' by leading potential defendants to spend more to prevent the activity that causes the economic harm ... than the cost of the harm itself.'; *Browning-Ferris Industries of Vermont, Inc v Kelco Disposal Inc*, 492 US 257, 282 (1989): 'The threat of such enormous awards has a detrimental effect on the research and development of new products.'; Paul H Rubin, John E Calfee and Mark F Grady, 'BMW v Gore: Mitigating The Punitive Economics of Punitive Damages' (1997) 5 *Supreme Court Economic Review* 179, 192-6.

51 Crump, above n 48, 197.

52 For a US example see 141 Cong. Rec. S 5571, 5576 (April 24, 1995) (statement of Sen. Gorton), 'only one company is willing to supply vaccines for polio, measles, mumps, rubella, rabies, and DPT. In 1984, two of the three companies manufacturing the DPT vaccine decided to stop production because of product liability costs.'

The concept of optimal deterrence would require Australian courts to refine the purpose of exemplary damages. At present deterrence is referred to in an imprecise manner. Adopting optimal deterrence would set the fact-finder a more specific goal that provided the incentive to stop conduct harmful to society but did not over-deter causing inefficient economic allocations or the loss of beneficial goods and services.

B *The Irrelevance of the Wealth of the Defendant*

Australian and US courts have traditionally allowed for evidence of the financial circumstances of a defendant to be admitted so that an award of exemplary damages is assessed in an amount that would make the defendant smart.[53] The majority in *Campbell* expressed concern that when jury instructions leave the jury with wide discretion in choosing amounts, and there is presentation of evidence of a defendant's net worth there is the potential for juries to use their verdicts to express biases against big business.[54] The Court also opined that in the specific case before it reference to the defendant's assets 'had little to do with the actual harm sustained by the [plaintiffs].'[55] Vague or unbridled references to wealth are impermissible in the US.

The position in *Campbell* is also supported by the economics of deterrence. As all corporations are profit-maximisers, the important criteria in setting exemplary damages is knowing the actual harm caused and what amount will make it economically rational to take the steps necessary to prevent the harm being repeated.[56] Whether a defendant is wealthy or poor, the cost-benefit calculation is the same. A wealthy defendant derives no greater benefit from a given action than a poor defendant, so that both will be equally deterred (or equally undeterred) by being required to pay damages. A defendant's existing assets do not increase the expected value of taking a given future action, such as deciding whether to install a safety device.[57] If reference is made to the airbag example above, it is obvious that wealth is not a factor in the determination of optimal

53 For an Australian example see *XL Petroleum (NSW) Pty Ltd v Caltex Oil (Australia) Pty Ltd* (1985) 155 CLR 448, 461 (Gibbs CJ), 464 (Murphy J), 472 (Brennan J). For American examples see Annotation, Punitive damages: relationship to defendant's wealth as factor in determining propriety of award, 87 ALR 4th 141 (1991); *Neal v Farmers Ins Exchange*, 21 Cal 3d 910, 928 (1978); *Green Oil Co v Hornsby*, 539 So 2d 218 (Ala 1989).

54 *State Farm v Campbell*, 538 US 408, 417 (2003).

55 Ibid 427.

56 Polinsky and Shavell, above n 42, 910-14.

57 Crump, above n 48, 217-23; Abraham and Jeffries Jr, above n 39, 417. See also *Zazu Designs v L'Oreal SA*, 979 F2d 499, 508 (7th Cir 1992) (Easterbrook J): 'For natural persons the marginal utility of money decreases as wealth increases, so that higher fines may be needed to deter those possessing great wealth. ... Corporations, however, are not wealthy in the sense that persons are. Corporations are abstractions; investors own the net worth of the business. These investors pay any punitive awards (the value of their shares decreases), and they may be of average wealth. Pension trusts and mutual funds, aggregating the investments of millions of average persons, own the bulk of many large corporations. Seeing the corporation as wealthy is an illusion, which like other mirages frequently leads people astray. Corporate assets finance ongoing operations and are unrelated to either the injury done to the victim or the size of the award needed to cause corporate managers to obey the law. Net worth is a measure of profits that have not yet been distributed to the investors. Why should damages increase because the firm reinvested its earnings?' See also *Kemezy v Peters*, 79 F 3d 33, 35 (7th Cir 1996) (Posner J).

deterrence. Whether the car manufacturer is exceptionally profitable or only just breaking even, it will make the decision about whether to install an airbag based on a comparison between its cost and the harm caused by not installing such a safety device.[58] Further, reference to the net worth of an entire corporation is misplaced because an exemplary damages award ceases to relate to the conduct that harmed the plaintiff and becomes about the entire corporation and the profits generated from unrelated activities. Even if punishment rather than deterrence is the goal of exemplary damages the punishment should fit the crime, not the criminal.[59] The financial circumstances of a corporate defendant are irrelevant to achieving optimal deterrence.

The adoption of the findings on the irrelevance of corporate wealth in Australia would require a significant change in what evidence is admissible in a case seeking exemplary damages.

V Implementing Deterrence

Optimal deterrence is supported by economic analysis, but there is doubt as to a jury's ability to achieve such a level of accuracy.[60] The US Supreme Court has also expressed its concern that vague jury instructions do little to aid the decision-maker in its task of assigning appropriate weight to evidence that is relevant and evidence that is tangential.[61] Further, '[j]urors may be told that punitive damages are imposed to punish and deter, but rarely are they instructed on how to effectuate those goals or whether any limiting principles exist.'[62] Similarly in Australia, the High Court has observed that 'there is little to be found in the cases which would identify the proper instructions to a jury for performing [the quantification of exemplary damages] function'.[63] In addition, the information necessary to reach an informed decision on exemplary damages may not be provided.

A *Cognitive Limitations*

Recent empirical studies in the US have determined that the cause of erratic punitive damages awards may arise from cognitive flaws in human decision-

58 See *Zazu Designs v L'Oreal SA*, 979 F 2d 499, 509 (7th Cir 1992) (Easterbrook J): 'Consider: General Motors is much larger than Chrysler, and so makes more defective cars, but the goals of compensation and deterrence are achieved for both firms by awarding as damages the injury produced per defective car.'

59 Andrew L Frey, 'Corporate Wealth: The 800-Pound Gorilla that Sabotages Fair Adjudication of Punitive Damages' (2004) 30 *Litigation* 8, 9.

60 Cass R Sunstein, Daniel Kaneman, and David Schkade, 'Assessing Punitive Damages (With Notes on Cognition and Valuation in Law)' (1998) 107 *Yale Law Journal* 2071, 2111.

61 *State Farm v Campbell*, 538 US 408, 418 (2003). See also *Gertz v Robert Welch Inc*, 418 US 323, 350 (1974): 'In most jurisdictions jury discretion over the amounts awarded is limited only by the gentle rule that they not be excessive. Consequently, juries assess punitive damages in wholly unpredictable amounts bearing no necessary relation to the actual harm caused.'

62 *TXO Production Corp v Alliance Resources Corp*, 509 US 443, 474-5 (1993) (O'Connor J dissenting).

63 *Gray v Motor Accident Commission* (1998) 196 CLR 1, 10.

making leading to a lack of consensus as to the threshold for punitive damages to be awarded and an inability to translate their outrage into a dollar amount.[64]

In relation to optimal deterrence, empirical studies have found:

- jurors are 'intuitive retributionists';
- jurors do not naturally think in terms of optimal deterrence;
- jurors do not follow instructions that guide them towards optimal deterrence;
- juries do not increase awards when the probability of detection is low (although a stealthy act may result in a higher award as it is more outrageous); and
- many jurors are reluctant or unable to carry out basic mathematical calculations.[65]

It has also been found that the amount of an award is more likely to be 'anchored' to the compensatory damages amount, or the plaintiff lawyer's request for punitive damages, than achieving deterrence.[66]

However, the above empirical studies tended to use a design whereby a mock juror was given realistic jury instructions that set out the purposes of punitive damages as punishment and deterrence. Accordingly, the jurors were not given the chance to differentiate between the goals of retribution and deterrence, or at least deterrence as an independent, non-retributive rationale.[67] Further, 'difficult punitive damages instructions, composed of unfamiliar and confusing terminology, [may] motivate jurors to rely on their intuitions, emotional reactions, and sympathy for the parties, rather than the law.'[68]

These findings can be interpreted in a number of ways. Exemplary damages should be abandoned because jury awards are arbitrary. In the United States, arbitrary punishment is unconstitutional. Although Australia does not have a Due Process Clause it does abide by the rule of law which also abhors arbitrary punishment. However, abandoning exemplary damages would have far-reaching ramifications as the inherent difficulty in making accurate exemplary damages awards also applies to damages for emotional distress, pain and suffering, defamation and the like.[69] The aim should be to remove, or at least reduce, the arbitrariness.

Another interpretation is that the jury is the wrong institution for awarding exemplary damages based on optimal deterrence because, although optimal deterrence makes economic sense, the economics involved are too complicated and people think in terms of punishment because it is more intuitive. Judges, in comparison, are less likely to award exemplary damages and if they do so they

64 Cass R Sunstein et al, *Punitive Damages – How Juries Decide* (2002), viii.
65 Ibid 25, 217, Chapters 8, 9.
66 Ibid 68-9.
67 Sharkey, above n 49, 391-2.
68 Sunstein et al, above n 64, 223; Neal R Feigenson, 'Can Tort Juries Punish Competently?' (2003) 78 *Chicago-Kent Law Review* 239, 275. The Australian High Court is aware of this problem, see, *Gray v Motor Accident Commission* (1998) 196 CLR 1, 10-11.
69 Sharkey, above n 49, 385.

do not award as large a sum as a jury does.[70] Although judges suffer from the same cognitive limitations as jurors they are better risk managers who tend to make economically efficient decisions consistent with optimal deterrence.[71] The removal of jury trials in the US would require a constitutional amendment.[72] Australia is therefore in a better position to act on such findings because juries are already used far less often than in the US and could be dispensed with in claims for exemplary damages if desired. However, Australian jurors and judges would benefit from more understandable explanations as to the economics of deterrence. It may also require the more radical solution of removing punishment as a purpose for awarding exemplary damages when the conduct results from cost-benefit considerations for which optimal deterrence alone should be the goal.

B *Availability of Information*

The above studies were structured so that information about the cost of precautions and likelihood of detection were provided and assumed to be accurate. In reality, a plaintiff would need to obtain access to this information and defendants must have a means to challenge its validity. This raises one of the criticisms of applying economic analysis to exemplary damages, that information quantifying the harm caused, the cost of precautions and the likelihood of detection is seldom available. While it is unlikely that complete information will ever be available, the discovery process and data collected by government authorities and research institutions may yield the necessary information for an economic analysis of exemplary damages. For example, the cost of tobacco use on the health system is measured by government and health organisations,[73] and precautions such as adding a label or a protective guard to machinery have an ascertainable cost that a defendant may know. Likelihood of detection is more difficult to quantify as it requires proving the number of instances a defendant was not caught or legal proceedings not commenced. It may be able to be extrapolated from other data such as complaints received and responded to, or the chances of detection may be expressed as high, moderate or low based on surrounding factors such as the vulnerability of those harmed (discussed further below).

C *Jury Instructions and Expert Witnesses*

For the jury to be able to achieve optimal deterrence it must be educated as to its meaning. There are two main methods for achieving this education – jury instructions and expert witnesses.

[70] Joni Hersch and W Kip Viscusi, 'Punitive Damages: How Judges and Juries Perform' (2004) 33 *Journal of Legal Studies* 1, 34.

[71] Sunstein et al, above n 64, 195-8.

[72] See US Constitution, Amendment VII, 'In suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved, and no fact tried by a jury, shall be otherwise reexamined in any court of the United States, than according to the rules of the common law.'

[73] See, eg, D Collins and H Lapsley, Commonwealth Department of Health and Ageing, *Counting the cost: estimates of the social costs of drug abuse in Australia in 1998-9* (2002).

Jury instructions should be structured to give juries a clear understanding of the role of exemplary damages and the weight they should accord evidence presented on exemplary damages.[74] From an optimal deterrence perspective it is critical that the jury be told to consider the amount of compensatory damages awarded and the social cost of the defendant's wrongful actions with a view to determining if compensatory damages alone are sufficient to deter a replication of the wrongful actions. Evidence of wealth will be inadmissible when dealing with wrongs arising from economic considerations, which will be most corporate decisions.[75] A jury must also receive instructions as to the factors to consider in determining whether wrongful conduct will be detected. This will vary with the specific conduct at issue. Factors to consider from *Campbell* and *Gore* include the target of the conduct – for example, preying on the financially vulnerable or those unable to protect themselves for reasons such as age or education is more likely to escape detection than conduct aimed at an equal. The defendant's response to finding out that its conduct was harmful or illegal is also relevant as it evidences whether it attempted to evade detection: did the defendant desist voluntarily or seek to cover-up the conduct?[76] Reprehensibility thus takes on a different role as its importance flows from what it tells the jury about the likelihood of detection.

In Australia expert evidence as to optimal deterrence would be allowed if that field of economic theory consisted of a reliable body of knowledge and a lay person was unable to form a sound judgment on the matter without expert assistance.[77] Economics is clearly a specialised field and the studies referred to above support the economics of deterrence being recognised as a sub-speciality. The above research on cognitive limitations demonstrates that jurors are unable to form sound judgments about the awarding of exemplary damages. However, the long historical practice of placing the award of exemplary damages solely in the jury's discretion would need to be revised. The jury would still exercise that discretion but would have the benefit of expert evidence that would provide a framework for jurors to determine whether exemplary damages were warranted and in what amount to achieve optimal deterrence. The goal of the framework constructed by expert evidence would be to reduce arbitrariness. Experts may also be a source of information quantifying the harm caused, the cost of precautions and the likelihood of detection that are inputs into the jury decision making process.

74 Sunstein et al, above n 64, 13.

75 Wealth will be relevant to wrongs motivated by non-economic considerations such as racial discrimination or sexual discrimination. See *Romano v U-Haul International Inc*, 233 F3d 655, 673 (1st Cir 2000) and *Zhang v American Gem Seafoods Inc*, 339 F3d 1020, 1043 (9th Cir 2003).

76 *State Farm v Campbell*, 538 US 408, 419 (2003) and *BMW of North America Inc v Gore*, 517 US 559, 576-7 (1996).

77 J Heydon, *Cross on Evidence* (2004), [29 050]; *Evidence Act 1995* (Cth) s 79 which provides: 'If a person has specialised knowledge based on the person's training, study or experience, the opinion rule does not apply to evidence of an opinion of that person that is wholly or substantially based on that knowledge.'

VI Conclusion

If exemplary damages are to serve their purpose and not be arbitrary then the fact-finder must be presented with evidence and a framework for interpreting that evidence. The Australian High Court has recognised that it is important to identify what circumstances entitle a plaintiff to an award of exemplary damages.[78] Yet the limits on the power to award exemplary damages have not been expressly defined and the monetary amount remains a matter of impression.[79]

The economics of deterrence and research on the cognitive limitations of jury members provide valuable lessons as to how the necessity and size of exemplary damages should be determined. In short, the law must distinguish between conduct resulting from cost-benefit considerations for which optimal deterrence should be the goal, and morally reprehensible conduct for which punishment should be the goal. In the case of the former, wealth or the financial circumstances of the defendant are irrelevant. Instead the fact-finder must be educated as to the economic theory behind optimal deterrence and receive evidence that allows them to apply that theory. The economics of deterrence are inexact but they provide a framework for the fact-finder that is based on reason rather than caprice.

[78] *Gray v Motor Accident Commission* (1998) 196 CLR 1, 12.
[79] *Backwell v AAA* (1997) 1 VR 182, 216; *Nye v New South Wales* (2004) Aust Torts Reports ¶81-725, [65 324].