

A Smart Use of Punitive Damages as a Stick for Regulation

Violators

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Abstract: Given the substantial enforcement costs of public authorities and the possible failure of liability, the joint use of regulation and liability is advanced. In case of a regulation violation, the imposition of punitive damages under a strict liability regime will give potential violators a strong incentive to comply with the law and save the enforcement costs as well by creating a discontinuous costs-function for potential violators. Under a negligence rule, the effect of imposing such punitive damages might not be as strong as under a strict liability rule, and it may exert stronger impact in one situation where the probability of escaping liability is high enough. For the amount of damages, in principle, it should be based upon the reciprocal to the probability of escaping liability.

Key Words: Punitive damages; Negligence per se; Strict liability; Discontinuity

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1. Introduction

The wide use of punitive damages in the U.S.A. has been criticized or condemned intensely by commentators as unpredictable and imposing unjustifiable burdens on firms.¹ It's said to be one of main causes leading to the liability crisis or insurance crisis in 1980's in the United States.² There are a lot of reform proposals to bar or

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¹ See, Cooter, Robert, Punitive Damages for Deterrence: When and How Much? Vol. 40, Alabama L. Rev., 1989, pp 1145.

² See, Priest, The Current Insurance Crisis and Modern Tort Law, 96 Yale L. J., 1521, 1987; also see, Elliot, Donald, Why Punitive Damages Don't Deter Corporate Misconduct Effectively, 40 Ala. L. Rev., 1053, 1989; Ellis, Dorsey D., Jr., Punitive Damages, Due Process, and the Jury, 40 Ala. L. Rev., 975, 1989.

restrict the use of punitive damages.³ In fact, there are some state statutes already having limited⁴ or eliminated the use of punitive damages under some circumstances.⁵

In this paper, the issue of whether or not to impose punitive damages is restricted to the situation where regulation⁶ and liability coexist, and injurers violate relevant regulatory standards and also inflict some harm on victims so they may be held liable for the harm in courts.⁷

There are two assumptions made in the paper: *the public enforcement of regulatory standards is costly; and liability rules alone can not induce all potential injurers to take a due care.* This leads to the joint use of regulation and liability, which will be further discussed in section 2.

In the third section, violation as negligence per se doctrine will be first introduced in order to show the readiness of courts to accept a regulatory standard when assessing the reasonableness of defendants' behavior. As long as courts are willing to take such a doctrine, the imposition of punitive damages will not be as difficult as a complete compliance defense for courts to accept since courts are not as certain to assess the optimality of a standard as to judge a violation of that standard.

Following that rationale, in section 4, the imposition of punitive damages under a strict liability regime will be justified in case of violation of regulation if the enforcement costs of regulatory agencies are high and the efficient level of deterrence may not be reached under liability rule with one condition: the relevant standard is not to be set too stringent. It can be shown that the introduction of punitive damages in this situation will give potential violators additional incentives to take more care or at least save enforcement costs given the deterrence level.

Under a negligence rule, the introduction of punitive damages for violators still works but may not be as strong as under a strict liability regime. In one particular situation, it

³ See, Schwartz, Teresa Moran, Punitive Damages and Regulated Products, 42 Am. U. L. Rev., 1992-1993, pp 1338; also see, Schwartz, Victor E. and Behrens, Mark. A., The American Law Institute's Reporters' Study on Enterprise Responsibility for Personal Injury: A Timely Call for Punitive Damages Reform, 30 San Diego L. Rev., 263, 1993.

⁴ See, Rustad, Michael, In Defense of Punitive Damages in Products Liability: Testing Tort Anecdotes with Empirical Data, 78 Iowa L. Rev., 1991-1993, pp 6-7 It's reported that since the middle 1980s, a majority of states have enacted tort reforms curbing punitive damages.

⁵ For example, if injurers have complied with the FDA regulation, in some states, the imposition of punitive damages has been barred. See, id., footnote 23; also see, Rosen, Abigail E., A Note: Analysis of An FDA Compliance Defense for Pharmaceutical Tort Litigation, 1 N.Y.U.J.L. & Bus., 2004-2005, pp 262-266; Schwartz, Teresa Moran, Punitive Damages and Regulated Products, 42 Am. U. L. Rev., 1992-1993, pp 1338 and footnote 17.

⁶ Here regulation only takes the form of a regulatory standard for the sake of simplification.

⁷ Whether the compliance with relevant standards can bar the imposition of punitive damages is not the focus of this paper though it's somehow related. The analysis of punitive damages from a law and economic perspective is abundant, however, to analyze its possible effect in the background of the combination of regulation and liability is not so much. So far, only one paper is directly taking such an approach, see, Innes (2004). The difference between the proposal in this paper and the suggestion in that paper will be discussed in the following text.

might deliver some more effective results.⁸

The insolvency risk will make any liability rule less effective in terms of deterrence, especially for a strict liability rule.⁹ If regulators can strategically enforce the law on those potential violators who are likely to be insolvent when introducing punitive damages, this problem can be reduced to some extent.

In the last part of the paper, the applicability and the possible problem of the proposal will be briefly discussed.

2. The justifications for the joint use of regulation and liability

Before going into the main topic, it's meaningful to first introduce the justifications for the joint use of regulation and liability since it's quite common that these two instruments work together in legal practice. From Shavell (1984 a, b),¹⁰ an informative analytical framework is established to point out the circumstances where one instrument might be superior to the other, and to give justifications for why the joint use of regulation and liability rule is more socially desirable.¹¹ Four determinants have been identified as main parameters affecting the relative desirability of each instrument to be employed. These four determinants are: 1) informational difference about risky activities; 2) the insolvency risk; 3) the possible failure of liability; and 4) the magnitude of administrative costs.

Since two determinants (administrative costs and informational difference) in general favor a liability regime, other two (the insolvency risk and the possibility of escaping liability) favor regulation, it seems that no one can be taken as the sole instrument for controlling harmful externalities. So it might be the case that the joint use of these two instruments can deliver more desirable result by curing its own problems to some extent. For example, a regulatory standard can be enforced by litigation *ex post* to save administrative costs; regulation, on the other hand, can solve the insolvency risk problem to which liability is vulnerable.¹²

As the coexistence of these two instruments has been justified theoretically, how courts in practice treat a violation of relevant regulatory standards will be introduced afterwards, which is also pertaining to the issue of imposition of punitive damages on violators because courts are more willing to hold a violator liable than to exonerate a complying one.

⁸ See the discussion in section 5.

⁹ See, Shavell, Steven, *Strict Liability vs. Negligence*, *The Journal of Legal Studies*, Vol. 9, No. 1, 1980, pp 1-25.

¹⁰ See, Shavell, Steven, *A model of the optimal use of liability and safety regulation*, *Rand Journal of Economics*, Vol. 15, No. 2, Summer 1984, pp 271-280; *Liability for harm versus regulation of safety*, 13 *J. Legal Studies*, 1984, pp. 357-374.

¹¹ This paper is a seminal one in the sense that it has established a Shavellian map to point out the factors to be considered and has shaped the direction of later research and debate on this issue. An extended model can be seen in Shavell, *Economic Analysis of Accident law*, Harvard University Press, 1987, pp 277-290.

¹² See, Shavell, Steven, *The Judgment Proof Problem*, 6 *International Review of Law and Economics*, 1986, pp 45-58.

3. Violation as negligence per se under a negligence rule

In legal practice, under a negligence rule, when an injurer has violated a relevant regulatory standard and inflicted some harm on victims, a doctrine, named as negligence per se rule, will apply. Basically, this doctrine means that the very injurer is negligent in a civil court once she violates a relevant regulatory or statutory duty. By referring to the negligence per se doctrine, courts, in fact, adopt standards from the relevant public law to define its own standard of care. Of course, for the doctrine to be applied in courts, it has to be ascertained that the purpose of the statute or regulation is to protect a particular class of persons or set of interests, the claimant must fall within that class or have had those interests violated to state a viable negligence per se rule.¹³

Traditionally, the reason for adopting such a doctrine is the deference of courts to the legislature.¹⁴ An economic justification for taking such a doctrine is: it can facilitate the enforcement of public law by saving the enforcement costs of public authorities. That's because as the ex post negligence rule can give potential violators a strong incentive to ex ante comply with the law, the ex ante public enforcement of the law might be unnecessary in the case where a negligence rule works effectively.¹⁵

Under the assumptions made in the paper, the enforcement costs of public authorities are substantial¹⁶ and liability alone can not deliver an efficient level of deterrence, it can be shown from the following analysis that it's still socially desirable to adopt such a doctrine. Since liability, here, a negligence rule is not functioning perfectly, it means that some potential injurers will not always take the required level of care because they might not be sued or found liable in courts for the possible failure of liability. Then the public enforcement of the law turns necessary. However, as being assumed, the public enforcement is costly, the problem a social planner is facing now is: to what extent the costly public enforcement to be deployed to control those harmful

¹³ See, Restatement (Second) of Torts § 286 cmt. f. In general, courts will take into account the following factors when deciding whether to apply the negligence per se doctrine: 1) violation of a statute or regulation; 2) the plaintiff is among the class of people for whose particular benefit the statute or regulation had been enacted; 3) recognition that a private right of action would promote the legislative purpose behind the statute or regulation; 4) creation of the right would be consistent with the overall legislative scheme. For the details of application of the negligence per se rule, in general, see, Kilpatrick, Richard B., *Negligence Per Se*, 22 *Gonz. L. Rev.*, 183, 1986-1987; for the application in different tort cases, see, Costa, Andrew E., *Negligence Per Se Theories in Pharmaceutical & Medical Device Litigation*, 57 *Me. L. Rev.*, 51, 2005; Bush, Sheila G., *Can You Get There from Here? Noncompliance with Environmental Regulations as Negligence Per Se in Tort Cases*; for the application in states, see, Sherman, Paul, *Use of Federal Statutes in State Negligence Per Se Actions*, 13 *Whittier, L. Rev.*, 831, 1992; Yowell, Paul, *Judicial Discretion in Adopting Legislative Standards: Texas's Solution to the Problem of Negligence Per Se*, 49 *Baylor L. Rev.*, 109, 1997.

¹⁴ See, Prosser, W. and Keeton, W., *The Law of Torts*, § 36, 5th ed., 1984, pp 222. But interesting enough, courts will defer to relevant regulatory standards when violation of such standards occurs by referring to negligence per se doctrine; they are not willing to defer as an injurer has complied with those relevant standards.

¹⁵ That a negligence rule functions effectively means that the standard of care defined by courts is certain and appropriate, and victims do bring a suit against injurers once harm occurs, then potential injurers will always have an appropriate incentive to take the required level of care to avoid being held liable except of some inadvertent outliers.

¹⁶ It's not an unrealistic assumption and, in fact, the enforcement costs of regulatory agencies are quite substantial. For this point, see, Stranlund, J. and Dhanda, K., *Endogenous Monitoring and Enforcement of a Transferable Emissions Permit System*, *Journal of Environmental Economics Management*, 1999, pp 267-282.

externalities for which liability is likely to fail to deter ex ante?

By applying negligence per se rule in this circumstance, potential victims will have an added incentive to bring a case and more likely to win a case *ceteris paribus*, which will make a liability rule more effective than without applying such a doctrine, which, in turn, will lead potential violators to ex ante comply with the law more readily, and meanwhile, the enforcement costs of public authorities will be saved to some extent given the deterrence level, or be used more efficiently for achieving a higher deterrence level.¹⁷ The kernel here is the reduced burden for victims on proving the negligence of injurers. Under a negligence rule, it's quite often the case that it's hard and controversy for victims to prove the negligence of injurers and for courts to assess whether the behavior of injurers is reasonable or not,¹⁸ which not only escalates the litigation costs and makes settlement more difficult, but leads to uncertainty as well.¹⁹ By referring to the well-defined standards in relevant statute or regulation, those issues will be solved to some or even a large extent for the following reasons: 1) the uncertainty about the content of standards will be reduced;²⁰ 2) the burden of proof for victims on negligence of injurers will be lessened so they are more likely to sue against injurers; 3) the case at issue might be easier to be settled so the total litigation costs can be reduced as well.

As far as courts use this doctrine with some caution,²¹ under the realistic assumptions in the paper, it can be shown that applying negligence per se rule in a civil court will facilitate the enforcement of public law and reduce relevant administrative costs by enhancing the incentive of victims to sue and reducing uncertainty about legal standards without reducing or even increasing their deterrence effect.

4. Violation as a condition for imposing punitive damages under a strict liability rule

Under a strict liability regime, whether an injurer complies or violates relevant regulatory standards seems irrelevant at the first sight because nevertheless the injurer has to bear all the costs created by his activities. However, under some conditions, imposing punitive damages on violators does make sense and can give potential

¹⁷ That's to say, to use the costly public enforcement on violations for which liability might not deter effectively.

¹⁸ See, Shavell, Steven, *Foundations of Economic Analysis of Law*, The Belknap Press of Harvard University Press, 2004, pp 224-230.

¹⁹ See, Calfee, John E. And Craswell, Richard, Some , 1984, *Effects of Uncertainty on Compliance with Legal Standards*, *Virginia L. Rev.*, Vol. 70, 965, 1984; Craswell, Richard and Calfee, John E., *Deterrence and Uncertain Legal Standards*, 2 *J. L. Econ. & Org.*, 279, 1986.

²⁰ It depends on how courts treat those regulatory standards. If courts treat them as an optimal and they indeed are optimal, then all the uncertainty would be eliminated; if courts treat them as a minimal one and impose a higher level of standard and whereby still hold a complying injurer liable, at least, the uncertainty with regard to the floor of required standards is eliminated.

²¹ See, supra note 13. There are some general accepted excuses for the application of negligence per se, for instance, Section 288A of the Restatement (Second) of Torts has listed the following excuses: 1) the violation is reasonable because of the actor's incapacity; 2) he neither knows nor should know of the occasion for compliance; 3) he is unable after reasonable diligence or care to comply; 4) he is confronted by an emergency not due to his own misconduct; 5) compliance would involve a great risk of harm to the actor or to others. In comment a to that Section, the Restatement also notices that list is not exclusive.

violators an additional incentive to comply with the relevant law at margin.

If the enforcement costs for regulation or liability is costless, the joint use of these two might be redundant and the efficient level of deterrence will arrive so the imposition of punitive damages will be useless or even inefficient.²² In reality, it's unlikely to reach such an efficient level of deterrence relying on one instrument fully.²³ The joint use of these two might cure some problems, for example, a strict liability can induce injurers to take an efficient level of care and activity as far as the damages set by courts are equal to the expected harm. If, for some reasons, the amount of damages is less than the expected harm, under-deterrence will occur.²⁴ In this case, regulation can give some incentives to those injurers who might be insolvent or not be sued were a strict liability be used alone.

Now under the assumptions that the enforcement for regulatory agencies is costly and strict liability alone can not achieve the efficient level of deterrence, given the insufficient enforcement level of regulatory agencies,²⁵ it can be shown that imposing punitive damages on violators can induce *solvent injurers* to take more care ex ante and thereby can increase the deterrence level. Or put it in another way, given the deterrence level of regulation and liability, the imposition of punitive damages on violators can save the enforcement costs of regulators. The reasons are as following:

From *Becker (1968)*²⁶ and *Stigler (1970)*²⁷, we know that given the constrained enforcement resources, an increase in the magnitude of sanctions will lead to the same deterrence level by reducing the probability of detection and conviction. Since the costs of increasing sanctions are often less than the costs of increasing detection and conviction, it will save enforcement costs for the same deterrence level. Or given the enforcement efforts, an increase in sanctions will lead a higher level of deterrence. Though being economically sound, there some counterarguments made against this arbitrary increase in sanctions.²⁸

²² It might be the case that errors pertinent to assessing the violation occur; the imposition of punitive damages will exaggerate those errors.

²³ See, Shavell, Steven, Liability for Harm Versus Regulation of Safety, 13 J. Legal Studies, 1984, pp. 357-374.

²⁴ There are a lot of reasons for that to happen. For instance, not every victim sues; even victims do sue, some of them might not win because of the difficulties in satisfying the legal requirements like proving the causation; or courts systematically underestimate the harm, for instance, in case of the value of life or the pain and suffering. See, Summers, J., The Case of The Disappearing Defendant: An Economic Analysis, Penn. L. Rev., 145, 1983.

²⁵ It's not an unrealistic assumption because the budget for relevant agencies is always constrained and they have to use their restricted resources wisely. See, Schwartz, Teresa Moran, Regulatory Standards and Products Liability: Striking the Right Balance between the Two, 30 U. Mich. J. L. Reform, 1996-1997, pp 445-446.

²⁶ See, Becker, Gary S., Crime and punishment: An economic approach. Journal of Political Economy 78, 1968, pp. 169-217.

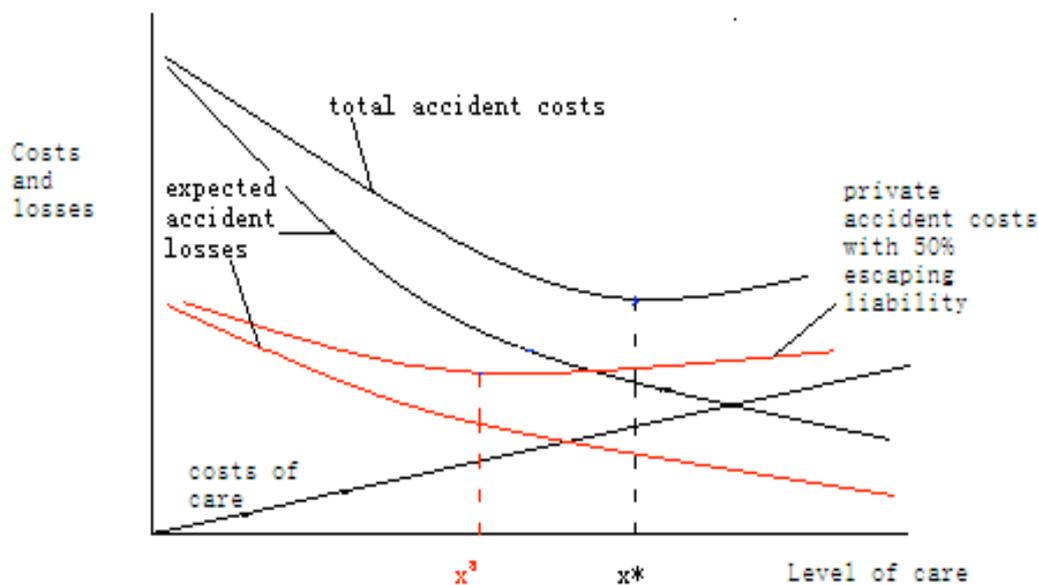
²⁷ See, Stigler, George J., The Optimum Enforcement of Laws, 78 J. Pol. Econ., 526, 1970.

²⁸ For instance, a drastic increase in sanction might eliminate the marginal deterrence effect on different types of crime. For this point, see, Stigler, George J., The Optimum Enforcement of Laws, 78 J. Pol. Econ., 526, 1970. They also neglect the moral basis, which has been embedded in the sanction of crime and set some limits on the magnitude of sanctions. For this point, see, Owen, David, G., The Moral Foundations of Punitive Damages, 40 Ala. L. Rev., 705, 1988-1989. For a literature survey on those arguments, see, Garoupa, Nuno, The Theory of Optimal Law Enforcement, Journal of Economic Survey, Vol. 11, No. 3, 267, 1997.

Before proceeding to main arguments, as a caveat, it has to be pointed out that, in this paper, the main purpose of imposing punitive damages is restricted to enhancing the incentive of potential regulation violators. It will mainly focus on the appropriateness and its possible effect on deterrence level of the proposal though, in the last part, when coming into its application, other policy considerations will be shortly discussed.

It's been well-established in the law and economic literature that strict liability is very sensitive to the amount of damages.²⁹ If victims don't bring a suit against injurers or injurers escape liability because of the difficulties for victims to prove the causation and harm, then the damages courts are going to reward is very likely to be less than the expected losses, which will lead injurers to take an inefficient level of care. It can be seen in figure 1.

Figure 1 The Level of Care of Injurers Who Escape Liability with 50% Probability Under a Strict Liability Rule

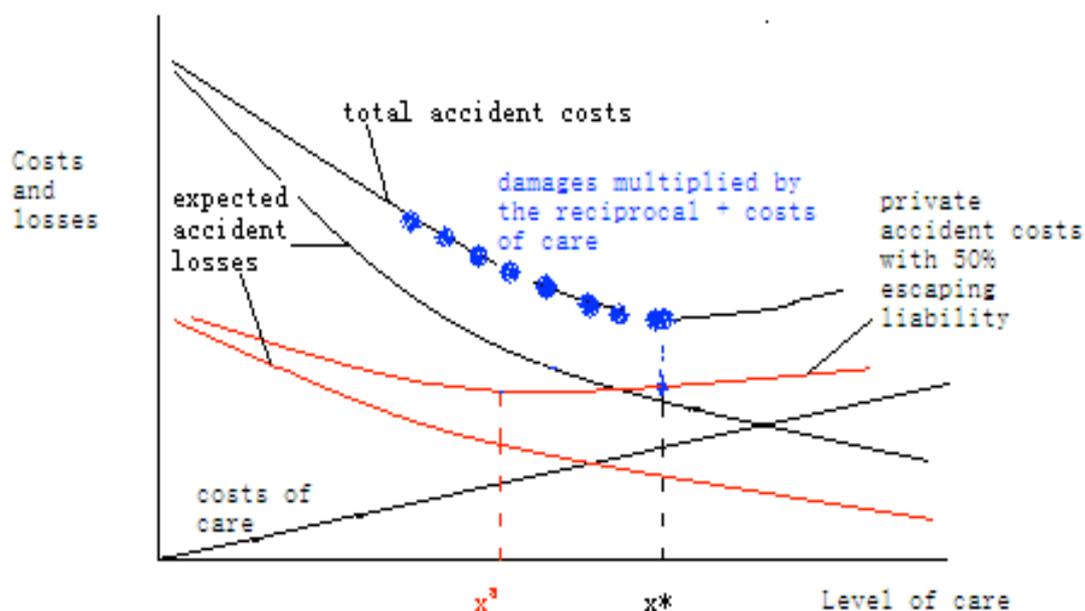


In figure 1, the social optimal level of care for an injurer is at x^* . If the injurer can escape liability with 50% opportunity, then that injurer might take too low level of care at x^a , which is corresponding to the private accident costs rather than the social accident costs. In this case, under-deterrence obviously occurs.

If courts impose the amount of damages taking into account the probability that injurers will escape liability upon the violation, then courts will create a discontinuity for injurers between complying with relevant standards and violating the law, which will induce potential violators to stick to the law. It can be captured in figure 2.

²⁹ See, Cooter, Robert, Prices vs. Sanctions, 84 Colum L. Rev. 1523, 1984 ; also see, Shavell, Steven, Strict Liability vs. Negligence, 9 J. Legal Stud., 1, 1980.

Figure 2 The Level of Care of Injurers under the Imposition of Punitive Damages Under a Strict Liability Rule



For instance, in figure 2, if courts impose damages multiplied by the reciprocal to 50%, and the relevant regulatory standard is an optimal one, say, at x^* , the potential violators will be induced to take that level of care. That's because, given the escaping probability, 50% here, if one injurer breaches the law, she will be liable for the damages multiplied by 2 plus the precaution costs; if she complies with the law, the minimal point of her private costs is exactly at x^* , which is far less than the possible damages. As her level of care decreases, the amount of expected damages will increase.

If the relevant regulatory standard is socially optimal, then the imposition of damages multiplied by the reciprocal to the probability of injurers escaping liability will lead potential violators to take the level of care, which is approaching to the efficient level.³⁰ If the relevant standard is suboptimal, imposing punitive damages still can give potential violators a strong incentive to abide by the law.³¹ As the probability of escaping liability increases, the discontinuity will increase as well, which at least corrects the wrong incentive structure of potential violators to some extent and forces them to take into account the possibility of being punished by punitive damages should they choose to breach the law.

³⁰ In theory, it can be assumed that the imposition of damages multiplied by the reciprocal can lead potential violators to take the required level of care. In legal practice, it's hard for courts to assess this reciprocal with such certainty, and some errors might not be avoidable. For this point, see, *infra* text.

³¹ In figure 2, it can be seen, as long as the relevant regulatory standard is higher than the care level of potential violators without imposing punitive damages, then the imposition of punitive damages will lead to a higher level of care. That's to say, in figure 2, as the required level is $> x^*$, the imposition of punitive damages will lead to a Pareto improvement.

As far as the imposition of punitive damages does constitute a threat to potential violators, at least those marginal potential violators will decide to follow the law, the enforcement costs of regulatory agencies, which would have been used were punitive damages not in the place, will be saved.³² Furthermore, regulatory agencies can focus its scarce resources on those potential violators, who are likely to be insolvent; who nevertheless can escape the liability; whose activities might cause severe consequence. For that to be realized, it needs some coordination among different institutions to cope with this under-deterrence problem with administrative costs as low as possible.

There is another line in literature to address this coordination problem by offering a carrot to potential violators in order to induce them to comply with relevant regulatory standards more often. Given the substantial enforcement costs, *Innes (2004)*³³ points out that by creating care-contingent sanctions and giving a complete exemption of complying injurers from possible liability, the ex-ante regulation will outperform the ex post liability.³⁴ *Lenntorp (2009)*³⁵ also suggests that when a licensing system and a strict liability regime coexist, a full regulatory compliance defense is desirable given the enforcement costs and associated distortions.³⁶

Here this paper is considering the another side of story, that's to say, instead of giving a carrot, an exemption for those complying injurers, it's to give those potential violators a stick by threatening them with possible punitive damages. It might be more appropriate and feasible to give a stick for violators than to offer a carrot for complying parties. That's because, first it's never certain whether the relevant standard under consideration is optimal.³⁷ If the standard at issue is the minimum one and courts do exempt those complying parties from liability, then under-deterrence will occur. In practice, it's also very hard to let courts accept such an approach and it's really contradicting to what the courts are often doing. What is commonly done in courts is that they often regard this regulatory compliance as the evidence of whether the injurer concerned is negligent or not, and the mere compliance can not rule out injurers' liability.³⁸

Under the proposal in this paper, these two problems might not constitute a big challenge. First of all, it's often easier for courts to find a violation of relevant regulatory standards than to ascertain the optimality of such standards because, for the

³² That's one of advantages of ex post liability vs. ex ante regulation in terms of administrative costs. See, Shavell, Steven, Liability for harm versus regulation of safety, 13 J. Legal Studies, 1984, pp. 357-374.

³³ See, Innes, Robert, Enforcement Costs, Optimal Sanctions, and the Choice between Ex-post Liability and Ex-ante Regulation, 24 International Review of Law and Economics, 2004, pp 29-48.

³⁴ It's said that it can leverage enforcement resources to greater effect by always sanctioning negligent conduct rather than only sanctioning such conduct when an accident occurs. See, id., pp 31.

³⁵ See, Lenntorp, Erik, On the Joint Use of Licensing and Liability, 29 International Review of Law and Economics, 2009, pp 244-251.

³⁶ That's because a full compliance defense will create a similar regime like negligence, which can reduce enforcement costs and litigation costs as well. See, id., pp 245-246.

³⁷ This issue will be discussed in another paper.

³⁸ For a general introduction to this issue, see, Tort and Regulatory Law, ed. by Willem van Boom, Meinhard Lukas, Christa Kissling, Springer, 1st. 2008.

former, the courts don't need to be cautious about whether a standard is optimal or which role they should play. Especially, when difficult technical questions are involved into the process of determining the optimality of relevant standards, courts even may not be able to fulfill this task properly.³⁹ For the second point, since, in legal practice, courts are ready to apply the negligence per se doctrine, it seems not difficult for courts to impose punitive damages for violators of regulation.⁴⁰

The main challenge to this proposal is the insolvency risk of potential violators.⁴¹ If potential violators are likely to be insolvent, the imposition of punitive damages will not give them any additional incentive to take more care. However, regulation can cure this problem to some extent. By strategically ex ante enforcing the law on regulated parties who are more likely to be insolvent, regulation can induce those parties to take appropriate care, then the imposition of punitive damages can effectively target on those solvent ones. Of course, to do that also requires some coordination between these two instruments.

Another challenge to this proposal is the stringency of the regulation. If the standard at issue is already too stringent, then the imposition of punitive damages on violators will not produce any efficiency gains and it might even lead to some inefficiencies.⁴² To prevent that from happening, one counterargument and one suggestion can be made. In theory, it's obviously not appropriate to impose punitive damages on violators when the standard is already too harsh. In practice, this case will not be often encountered in comparison to other situations where the relevant standards are optimal or minimal. If it does occur, an excuse could be added: as long as violators can successfully prove that the standard at issue is already too stringent, the imposition of punitive damages will not apply.⁴³

As for the amount of punitive damages, as a principle, it should be based on the reciprocal to the probability of injurers escaping liability.⁴⁴ In so doing, it can restore the distorted incentive of potential violators when escaping liability is possible as if

³⁹ See, Viscusi, Product liability and Regulation: Establishing the Appropriate Institutional Division of Labor, 78, AEA Papers and Proceedings, No. 3, 1988, pp 300-304.

⁴⁰ Besides other policy considerations, this phenomenon that courts are reluctant to adopt a full exemption for complying injurers but more willing to hold violating injurers liable, could be explained by insights from behavioral economics: courts might be more willing to use its discretion by adopting a regulatory standard than to limit its discretion by deferring to such a regulatory standard even though assuming that standard is optimal. See, Kahneman, Daniel et al., Experimental Tests of the Endowment Effect and the Coase Theorem, in Behavioral Law and Economics, ed. by Sunstein, Cass R., Cambridge University Press, 2000, pp 211-231.

⁴¹ See, Shavell, Steven, The Judgment Proof Problem, 6 International Review of Law and Economics, 1986, pp 49-54.

⁴² For instance, it might induce potential violators to take too much care or even deter them from entering the relevant markets.

⁴³ To be more precisely, in order to be exempted from the imposition of punitive damages, a violator not only has to prove that the required level of care is unreasonably stringent but also needs to prove that he has taken due care as well.

⁴⁴ For this line of recommendations, see, Stigler, George J., The Optimum Enforcement of Laws, 78 J. Pol. Econ., 526, 1970; Cooter, Robert, Punitive Damages for Deterrence: When and How Much? Vol. 40, Alabama L. Rev., 1143, 1989; Polinsky, Mitchell A. and Shavell, Steven, Enforcement Costs and the Optimal Magnitude and Probability of Fines, NBER Working Papers Series, No. 3429, 1990; Polinsky, Mitchell A. and Shavell, Steven, Punitive Damages: An Economic Analysis, Harvard L. Rev., Vol. 111, No. 4, 869, Feb. 1998.

such a probability didn't exist. It has to be pointed out that, in legal practice, it's not easy for courts to assess this reciprocal.⁴⁵ To better guide the assessment of courts, a rule of thumb might be more practical.⁴⁶ For instance, the American College of Trial Lawyers has recommended that punitive damages should be limited to twice the amount of compensatory damages awarded, or \$250,000, whichever is greater.⁴⁷ When plaintiffs' harm is minimal, a ceiling on the amount of punitive damages, for example \$25,000, could be set.⁴⁸ All similar recommendations like the above one will reduce the unpredictability of punitive damages awards to some extent.⁴⁹

In short, the imposition of punitive damages on regulation violators under a strict liability regime will in fact transmit this strict liability regime into a quasi-negligence rule where there exists a discontinuity of costs for potential violators between obeying the law and breaching the law, which undoubtedly gives potential violators a stronger incentive to follow the law and can be viewed as desirable as far as the law is not too restrictive. This imposition also has another implicit benefit: it can save enforcement costs for regulators and thereby enabling them to allocate their scarce resources to other more needed areas or target at more severe or repetitive offenses.

5. Violation as a condition for imposing punitive damages under a negligence rule

Under a negligence rule, this proposal still works if though it may not be as strong as under a strict liability regime. That's because the negligence per se doctrine already gives potential violators a strong incentive to abide with the law; imposition of punitive damages on violators hence only has some marginal effect. However, it can be shown that, if the probability to escape liability is high enough, the imposition of punitive damages will become more effective. From literature, it's well-known that if the harm spread over numerous victims and each victim only sustains a fraction of harm, it may not pay for victims to sue because the gain from winning a case might not exceed the litigation costs.⁵⁰ If punitive damages are imposed for violators in this

⁴⁵ There are some suggestions for how this to be done, see, Cooter, Robert, Punitive Damages for Deterrence: When and How Much? Vol. 40, Alabama L. Rev., 1989, pp 1176; Sunstein, Cass R., et al., Assessing Punitive damages (With Notes on Cognition and Valuation in Law), Yale L. J., Vol. 107, No. 7, 1998, pp 2071-2153.

⁴⁶ See, Owen, David, G., The Moral Foundations of Punitive Damages, 40 Ala. L. Rev., 1988-1989, pp 731-738.

⁴⁷ See, American College of Trial Lawyers, Report on Punitive Damages of the Committee on Special Problems in the Administration of Justice, Mar. 3, 1989, pp 15.

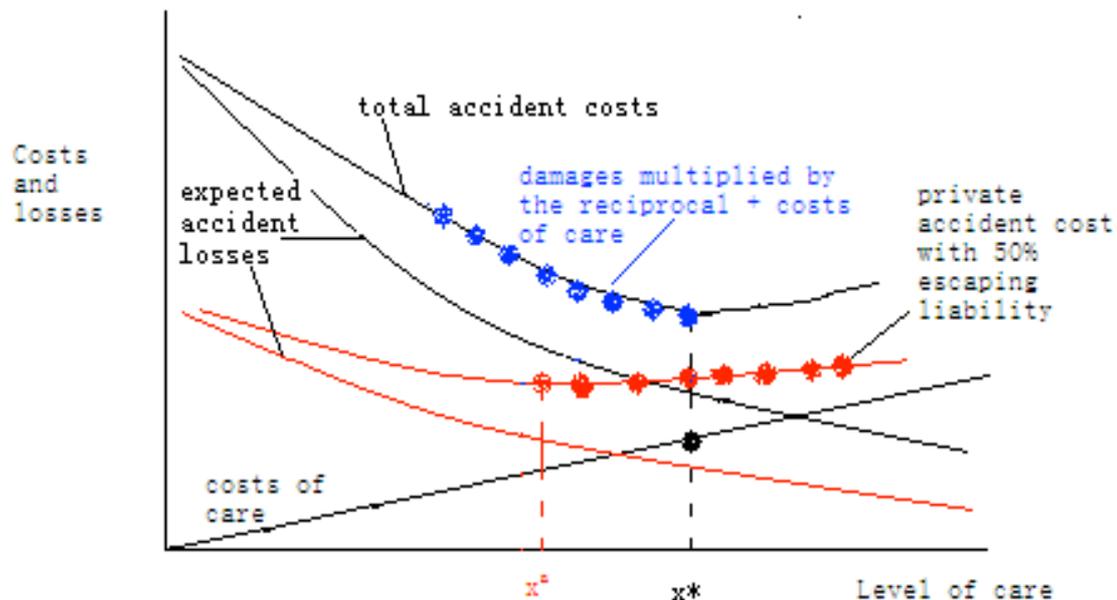
⁴⁸ See, American Law Institute, Reporters' Study on Enterprise Responsibility for Personal Injury: Approaches to Legal and Institutional Change, 1991.

⁴⁹ This limitation of amount of punitive damages seems arbitrary at the first sight; nevertheless, it can reduce the unpredictability problem of punitive damages. In fact, the amount of punitive damages does not matter too much because of the transmission from a strict liability rule to a quasi-negligence rule, which is not sensitive to the amount of damages. As far as the relevant regulatory standards are certain, the amount of punitive damages would not change the result so the seemingly arbitrary limitation of punitive damages will reduce the unpredictability to a large extent without losing its incentive-enhancing role. There are some empirical studies also showing that there is significant correlation between the amount of compensatory damages; and the amount of punitive damages is slightly more than compensatory damages, the median ratio of punitive damages to compensatory damages awarded at trial is 1.67 to 1. See, Rustad, Michael, In Defense of Punitive Damages in Products Liability: Testing Tort Anecdotes with Empirical Data, 78 Iowa L. Rev., 1991-1993, pp 50, footnote 228; also see, Eisenberg, Theodore, et al., The Predictability of Punitive Damages, 26 J. Legal Stud., 623, 1997.

⁵⁰ See, Polinsky, Mitchell A. and Rubinfeld, D., The Welfare Implications of Costly Litigation for the Level of Liability, Journal of Legal Studies, 17, 1988, pp 151-164; Optimal Awards and Penalties when the Probability of

case and victims know that, the probability of potential violators facing a suit will certainly be higher because now it might pay for victims to bring a case against those injurers *ceteris paribus*, which will lead potential violators to take more care ex ante.

Figure 3 The Level of Care of Injurers Who Escape Liability with 50% Probability Under a Negligence Rule

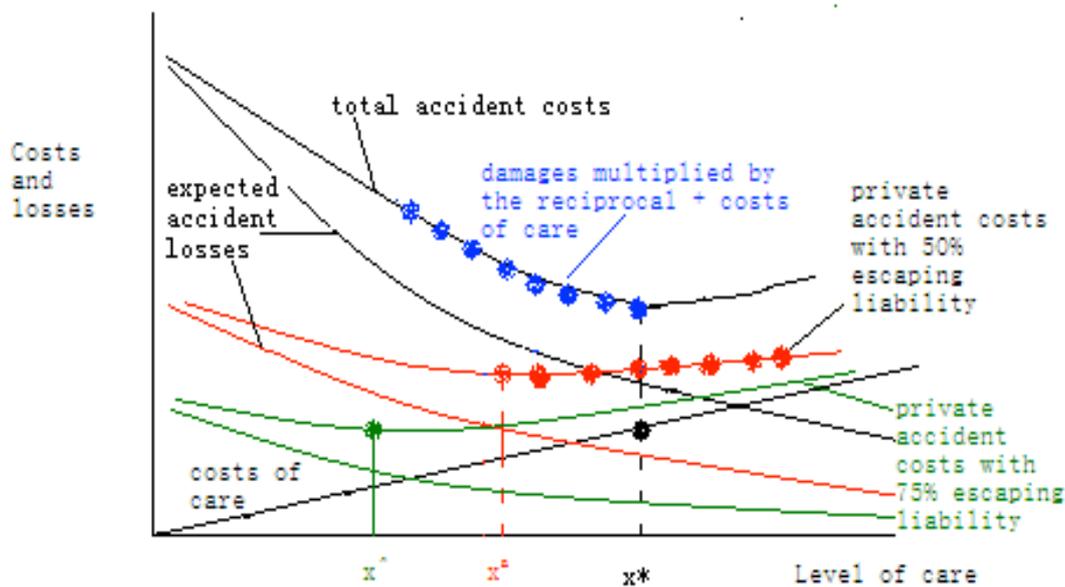


In figure 3, it can be seen that even with 50% probability to escape liability under a negligence rule, the potential violators are still likely to take the required level of care, x^* , not the minimal point, x^a .⁵¹ That's because if an injurer takes x^a , she will be held liable for all accident costs, which are clearly exceeding the costs of care at the required level, x^* ; by sticking to that level, the injurer will avoid the possible liability so she will take that level of care. If, in this case, the amount of damages is multiplied by the reciprocal, it will not change the result and only reinforce the incentive for potential violators to comply with the law. Unless the probability to escape the possible liability is high enough, then the imposition of punitive damages might correct the distorted incentive of potential violators, which can be captured in figure 4.

Figure 4 The Level of Care of Injurers Who Escape Liability with 75% Probability Under a Negligence Rule

Prevailing Varies Among Plaintiffs, Rand J. Econ., 27, 1996, pp 269-280.

⁵¹ If the required level of care is inefficiently high enough, potential violators might take x^a , which is the minimal point of her private costs as if a strict liability rule were used. If introducing punitive damages in this case, it might lead potential violators to take the required level of care but the result is not socially efficient and it will lead to over-deterrence.



In figure 4, if the probability to escape liability increases to 75%, potential violators will take x^{\wedge} , instead of x^* , even under a negligence rule. If punitive damages are imposed in this case, the potential violators will be forced to take the required level of care again.

Under the negligence rule, if a violator can prove the standard at issue is too restrictive and she has taken due care in courts, she can be exonerated from liability including punitive damages.⁵²

6. Concluding remarks

In the last part of this paper, two practical issues concerning the application of this proposal will be addressed. The first one could be the concerns as to the number of law suits, some of which might not be credible and nevertheless induced by the imposition of punitive damages. In order to claim for punitive damages, the claimant has to prove there is a violation of relevant regulatory standards. Normally, to assess whether a violation has occurred or not is not as difficult as to assess whether the injurer is negligent or not, the errors courts might make are not likely to be a big concern unless the content of relevant standards is very vague. Furthermore, from an ex ante point of view, potential injurers will have a strong incentive to abide by the law in order to avoid the imposition of punitive damages. As long as they are not violating the law, the claims for punitive damages can be simply dismissed so the concerns for frivolous suits induced by imposing punitive damages might not be as serious as it's been seen first.⁵³

⁵² Under a strict liability regime, the injurer can only be exempted from the imposition of punitive damages but not for the harm.

⁵³ It will, of course, incur some additional administrative costs to assess the violation. However, as far as the benefits from imposing punitive damages are likely to be larger than those added costs, the imposition will be

Another concern is about the scope of this proposal. As mentioned above, violation of relevant standards is just a necessary condition for courts to consider whether or not to impose punitive damages, not a sufficient condition so, in that sense, the scope of this proposal is quite limited. It's a matter of discretion of judges to balance the potential gains and costs by taking into account those factors: the violation of relevant standards, the intention of violators,⁵⁴ the strictness of relevant standards,⁵⁵ As for the magnitude of harm inflicted on victims, it might be one factor when courts assess the amount of damages, but it shall not be a factor when courts assess the applicability of punitive damages.⁵⁶

The imposition of punitive damages can only be justified as long as the benefits from imposing punitive damages are very likely to exceed the costs incurred. For example, a clear case would be where the enforcement costs of regulator for regulating one particular activity is quite large and meanwhile normal damages rule would not give victims an effective incentive to sue in the first place were harm occur, then the introduction of punitive damages might be beneficial because it can not only save the enforcement costs of regulators; more importantly, it can induce those potential injurers who might strategically choose to breach the law, to take a more appropriate level of care. At end, an effective coordination between regulation and liability is still needed.⁵⁷

socially desirable.

⁵⁴ It's still necessary to consider the intent of injurers because the imposition of punitive damages is mainly targeting at those injurers who might deliberately choose to breach the law, taking into account the probability of escaping the possible liability, not for those, who are just randomly or inadvertently violating the law, for which the imposition of punitive damages may not deter and only lead to higher litigation costs. Besides the deterrence consideration, relating the imposition of punitive damages to the intent of injurers also has a sound moral basis. For this point, see, Owen, David, G., *The Moral Foundations of Punitive Damages*, 40 *Ala. L. Rev.*, 705, 1988-1989; *A Punitive Damages Overview: Functions, Problems and Reform*, 39 *Vill. L. Rev.*, 363, 1994; also see, Cooter, Robert, *Punitive Damages for Deterrence: When and How Much?* *Ala. L. Rev.*, Vol. 40, 1989, pp 1148, in which, the author proposes a gross shortfall standard for business defendants.

⁵⁵ If injurers can prove the standard at issue is too stringent successfully, the imposition of punitive damages will be inappropriate and thereby courts shall dismiss the claim. See, Owen, David G., *Punitive Damages in Products Liability Litigation*, *Michigan L. Rev.*, Vol. 74, No. 7, 1976, pp 1335-1339.

⁵⁶ It's beneficial to distinguish these two different questions at least in this paper because the main purpose to impose punitive damages has been assumed to give an incentive to those injurers who might strategically choose to breach the law to take a more appropriate level of care. When the magnitude of harm comes into the decision regarding the imposition of punitive damages, it might blur the main function of punitive damages assumed in this paper. For this point, see, Owen, David, G., *The Moral Foundations of Punitive Damages*, 40 *Ala. L. Rev.*, 1988-1989, pp 723.

⁵⁷ In this paper, the comparison between the imposition of punitive damages and fines imposed for a criminal act is not made. Nevertheless, one point is worth noticing, the burden of proof for a criminal act is clearly higher than the burden in a civil court, which means that higher litigation costs will be incurred to deter deliberate violations, which might be deterred effectively at lower costs were punitive damages be imposed. For the comparison between liability and criminal law, see, Polinsky, Mitchell A., *Private versus Public Enforcement of Fines*, *The Journal of Legal Studies*, Vol. IX, No. 1, (January 1980), pp. 105-127.

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