BMW v GORE:
MITIGATING THE PUNITIVE ECONOMICS OF PUNITIVE DAMAGES

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In BMW v Gore, *the Supreme Court held that a state court's award of punitive damages was so excessive that it violated the Due Process Clause. In three other recent cases, the Court had rejected due process challenges to large awards of punitive damages. Although the Court did not articulate an economic rationale, these four cases are consistent with a theory under which federal courts should intervene only when there is a high risk that punitive damages will systematically appropriate wealth from the citizens of other states. Rather than apply due process analysis directly to punitive damages awards, the Court might more usefully revise the constitutional rules regulating the exercise of long-arm jurisdiction. With clear and realistic rules allowing firms to avoid states in which juries are not adequately restrained, the mechanisms of federalism would adequately control excessive punitive damages. Gore may be an effort to approximate this result by other means.*

I. INTRODUCTION

The facts in *BMW of North America, Inc. v Gore*[1] are relatively simple. Dr. Ira Gore purchased a new BMW for approximately $40,000. After driving it for nine months, he decided to have some custom body work done. He learned from the body shop that part of the car had been repainted by BMW before sale at an estimated cost of $600. Gore sued BMW, alleging that the repainted vehicle was worth less than it would have been had the paint not been damaged in the first place, and that the failure to disclose the repainting was fraud. BMW, which frequently repainted surfaces damaged by acid rain on the trip from Germany, explained that they did not

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[1] 116 S Ct 1589 (1996).

notify dealers (and thus customers) of repairs costing less than 3% of the value of the car, and that many states had laws that explicitly exempted repairs of this amount from disclosure requirements. BMW also revealed that 983 consumers nationwide, including 14 in Alabama, had unknowingly purchased repainted cars since BMW began this policy in 1983. The jury awarded $4,000 in compensatory damages, based on testimony that a repainted car is worth 10% less than a nonrepainted car, and added $4 million in punitive damages to reflect the losses presumably suffered by the 1,000-odd American consumers who had been similarly treated under BMW's policy. The Alabama Supreme Court reduced the punitive damages award to $2 million because the jury should not have considered injuries to consumers outside Alabama, but the court did not explain further how it calculated the $2 million figure. The United States Supreme Court found the $2 million award excessive and remanded the matter back to the Alabama courts.

Gore is the fourth recent Supreme Court case involving the amount of punitive damages awarded by a jury.[2] In the first, *Browning-Ferris Industries v Kelco Disposal, Inc.*[3] the Court indicated that it might accept a challenge to punitive damages, but that the proper constitutional basis for such a challenge would be the Fourteenth Amendment Due Process Clause, rather than the Eighth Amendment's Excessive Fines Clause on which Browning-Ferris had relied. In the next two cases, *Pacific Mutual Life Insurance Co. v Haslip*[4] and *TXO Production Corp. v Alliance Resources Corp.,*[5] the Court held that the punitive damages at issue did not violate the Due Process Clause, but continued to leave open the possibility that excessive punitive damages could be unconstitutional in some circumstances. In *Gore,* the Court has finally found a case of punitive damages that violated the Constitution.[6]

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[2] A fifth case examined procedural matters associated with punitive damages: *Honda Motor Co. Ltd. v Oberg,* 112 S Ct 415 (1994), discussed below.

[3] 492 US 257 (1989).

[4] 499 US 1 (1991).

[5] 509 US 443 (1993).

[6] Repeated litigation of the same issue until a favorable ruling is obtained is consistent with the evolutionary models of legal change. Paul H. Rubin, *Why Is the Common Law Efficient?,* 6 J Legal Stud 51 (1977). Indeed, Paul H. Rubin and Martin J. Bailey, *The Role of Lawyers in Changing the Law,* 23 J Legal Stud 807 (1994) ("Rubin & Bailey, *The Role of Lawyers*"), used punitive damages as an example of a legal issue where business firms have sufficient common interests to continue litigating the issue, and they predicted continuing litigation of this issue. They pointed out that numerous *amici* briefs were filed in the three punitive damages cases that had then been

One interesting aspect of this case is that the two Justices who generally favor markets and efficiency most strongly, Scalia and Thomas, dissented on federalism grounds (as did Justice Ginsburg and Chief Justice Rehnquist, in a separate dissent). Thus, in analyzing this matter it will not be enough to discuss the economics of punitive damages. Rather, it will be necessary to consider as well the jurisdictional issue: What are the efficiency implications of federal review of state determinations of damages?

This article addresses three topics: the economic aspects of punitive damages, with an emphasis on the changing role of punitive damages in the marketplace; the *Gore* decision from this economic perspective; and the federalism issue, also from an economic perspective. At the end, we raise some questions about the future course of Supreme Court punitive damages litigation.

II. RECENT DEVELOPMENTS IN PUNITIVE DAMAGES FROM AN ECONOMIC PERSPECTIVE

The laws of most states permit juries to award punitive damages for tortious actions that fit verbal criteria such as "reprehensibility." In Alabama, where the *Gore* case arose, the law allows punitive damages awards for a fraud that is "gross, oppressive, or malicious." Punitive damages traditionally have no limits other than the predilections of juries and the willingness of appeals courts to reduce awards or set them aside. This is no longer true in many states,[7] but it was and is true in Alabama.

Punitive damages are usually assumed to serve two functions: punishment (or retribution), and deterrence.[8] A third possible function is improving the compensatory role of tort law. Most economists have agreed that the major efficiency goal of the tort system should be deterrence, with compensation serving primarily as a tool rather than a goal.[9] Some have argued that the tort

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litigated before the Supreme Court. This sequence of cases is therefore evidence for the hypothesis that law is driven by litigants seeking favorable precedents, the central force in evolutionary models of legal change.

[7] See the appendix in Justice Ginsburg's dissent in *Gore,* 116 S Ct at 1618-19.

[8] See, for example, Bruce Chapman and Michael Trebilcock, *Punitive Damages: Divergence in Search of a Rationale,* 40 Ala L Rev 741 (1989).

[9] See, for example, William M. Landes and Richard A. Posner, *The Economic Structure of Tort Law* (Harvard U, 1987) ("Landes & Posner, *Economic Structure of Tort Law*"); Steven Shavell, *The Economic Analysis of Accident Law* (Harvard U, 1987) ("Shavell, *Economic Analysis of Accident Law*").

system has shifted its focus from deterrence to compensation, especially for nonpecuniary losses such as pain and suffering, with the paradoxical effect of imposing unnecessary financial burdens and increased risk on consumers.[10] Some have also argued that punitives have become more available. If so, this would alter the role of punitive damages in the tort system, with important economic consequences.[11] *Gore* is best seen in this context of an evolving system with rapidly changing economic effects. We argue that deterrence is the only reasonable objective for punitive damages, and that even this objective only makes sense for torts that are intentional or reckless. We then offer an analysis of the market effects of punitive damages (which have clearly come to encompass many nonintentional torts), to illustrate the dangers of an expansive role for punitive damages.

A. Intentional Torts

The academic literature provides a persuasive theoretical foundation for punitive damages as a deterrent against torts that are intentional or involve reckless disregard for harm to others, including egregious forms of intentional negligence.[12] The reasoning is akin to that for sanctions against criminal behavior, where economic reasoning suggests that merely requiring compensation for harm in cases where perpetrators are apprehended and convicted is insufficient to deter the intentional infliction of harm, especially when the chances of apprehension are small. Similarly, attempted tortious harm, such as a fraud that is discovered before it can have effect, is like an uncompleted criminal act such as attempted murder, and thus may merit strong sanctions even if the harm is modest or nil.[13] The implication is that a specified penalty structure may be difficult to spell out in legislation, so that penalties are best left for juries to assess in light of the

[10] See, for example, John E. Calfee and Paul H. Rubin, *Indicting Liability: How the System Raises Prices and Increases Risk* (AEI, forthcoming 1997) ("Calfee & Rubin, *Indicting Liability*").

[11] Id.

[12] On economic theories of punitive damages, see Robert Cooter, *Punitive Damages for Deterrence: When and How Much?*, 40 Ala L Rev 1143 (1989) ("Cooter, *Punitive Damages for Deterrence*"), and other articles in the same issue of the *Alabama Law Review.* See also David D. Haddock, Fred S. McChesney, and Manachem Spiegel, *An Ordinary Economic Rationale for Extraordinary Legal Sanctions,* 78 Cal L Rev 1 (1990). Grady has also distinguished between "inadvertent" and "intentional" negligence. Mark F. Grady, *Punitive Damages and Subjective States of Mind: A Positive Economic Theory*, 40 Ala L Rev 1197 (1989); and Mark F. Grady, *Res Ipsa Loquitur and Compliance Error,* 142 U Pa L Rev 887 (1994).

[13] See Steven Shavell, *Deterrence and the Punishment of Attempts,* 19 J Legal Stud 435 (1990); David D. Friedman, *Impossibility, Subjective Probability, and Punishment for Attempts,* 20 J Legal Stud 179 (1991).

known circumstances.

Thus, for example, when a corporation, through its principal officers, has been intentionally and egregiously negligent--for instance, by selling blood that the officers knew could be infected with the HIV virus--it would likely be a proper case for punitive damages, both from an economic and from a legal point of view. More troublesome cases arise when a plaintiff seeks punitive damages for the intentional tort or intentional negligence of a low-ranking employee. Traditionally, a corporation would not be liable for these damages, because typically the employee would have been acting outside the scope of his employment; yet, modern law is more generous to plaintiffs. For instance, in the *TXO* case discussed below, the defendant's employee committed an intentional tort (fraud), but the corporation did not. Under Alabama law, however, the corporation was liable for the punitive damages awarded because of the employee's act. This type of state rule is not always efficient, because it can induce the corporation to investigate employees too intensively and to monitor too closely. Unless the senior managers of a corporation have deliberately closed their eyes to evidence that an employee has committed or is about to commit an intentional tort or intentional negligence, it would seem that the corporation's vicarious obligation to pay actual damages would be an economically adequate deterrent.

Even when punitive damages are limited to intentional torts, they raise several practical difficulties. Chief among these are the fact that punitive damages are both unlimited and unpredictable. They are unlimited in two distinct ways. One is that juries may impose whatever level of penalties they desire. The courts (including the Supreme Court in *Gore*) have yet to establish a workable way to impose a rational relationship between actual harm and punitive damages.[14] Punitive damages are also unlimited in the sense that tortfeasors may be assessed punitive damages several times for the same offense. Injuries arising from product design, for example, may affect many consumers, with punitive damages being available in each case. The legal system provides no mechanism for coordinating damages payments received by more than one injured party. Punitive damages may therefore be "leveraged" into effects that are grossly disproportionate to the amount of awards that are actually handed down in specific cases.

In addition to being unlimited, punitive damages are unpredictable. Firms cannot know what penalties would arise from specific behaviors, and so cannot make plans with a reasonable

[14] This lack of guidance led Justice Scalia to proclaim: "One might understand the Court's eagerness to enter this field … if it had something useful to say." *Gore*, 116 S Ct at 1612 (Scalia, dissenting).

degree of certainty. This set of facts makes it impossible for punitive damages to serve in any systematic sense as a penalty "multiplier" to achieve optimal deterrence.

These characteristics make punitive damages essentially unique among legal penalties. Of course, various parts of the legal system provide for penalties that may exceed compensation for harm. In addition to punitive damages, these include criminal penalties, contractually specified damages payments, and perhaps class action litigation.[15] But in all these cases, the amount available to plaintiffs is limited and relatively predictable. This is so despite the fact that acts covered by punitive damages under tort are often less harmful than acts covered by other penalty arrangements. Criminal penalties, for example, are limited by statute and by the statute-based Federal Sentencing Guidelines. Damages are also limited under the Racketeering Influenced Corrupt Organizations statute (RICO), which is the law used to prosecute organized crime; in civil RICO cases, which are brought by private parties, potential damages are three times the harm.[16]

Thus, while damages for tortious harms are unlimited, they are strictly limited for criminal acts. This is ironic. Logic would suggest an opposite relationship. Common law criminal acts such as murder, theft, and forcible rape have long been regarded as invariably inefficient because the utility of such acts to the criminal seems so clearly to be strongly outweighed by the disutility to the victims.[17] Apart from the error costs in operating the legal system, there would seem to be little danger of overdeterring such acts as a class. Except for some torts that are essentially identical to common law criminal acts, however, such as the intentional infliction of bodily harm, overdeterrence is a real danger when punitive damages are available. Most tortious conduct is part of a broader action, and the broader action is generally basically useful. A doctor who has been negligent once may nonetheless provide useful medical care. The manner in which

[15] In a class action suit, while damages may be excessively large, there is at least a protection against "double jeopardy" of the sort associated with punitive damages.

[16] This is itself an excessive penalty. See Paul H. Rubin and Robert Zwirb, *The Economics of Civil RICO,* 20 UC Davis L Rev 883 (1987).

[17] Compare George J. Stigler, *The Optimum Enforcement of Laws,* 78 J Pol Econ 526, 527 (1970) ("It may be that in a few offenses some gain to the offender is viewed as a gain to society, but such social gains seem too infrequent, small, and capricious to put an effective limitation upon the size of punishments." (footnote omitted)). We set aside the modern "regulatory" crimes, where there are often strong possibilities that the proscribed behavior is actually efficient.

the care is provided in a specific instance may be deserving of punishment, but this is not true of the act of providing care itself. Similarly, a product may be "excessively" dangerous even though the product provides value, so we want to the deter the danger but not the product.

Another oddity about the lack of limits on punitive damages arises from the fact that courts may disallow liquidated damages based on a contractual agreement if the damages are so large as to be punitive. Yet for identical contractual breaches, the courts are often willing to approve huge punitive damages in the context of a tort suit.

From an economic perspective, damages serve the same deterrence function in all these cases (torts, common law crimes, and contracts), so it is surprising that the courts treat them so differently. It seems bizarre that the least harmful class of activities--non-criminal activities, where the parties have not specified a level of damages *ex ante* and where the tortfeasor has not engaged in a pattern of harm to multiple victims sufficient to justify class action litigation--may generate the largest penalties.

These considerations suggest that the traditional tort law of punitive damages has made it easy for juries to make excessive punitive damages awards. Yet punitive damages have historically been rare and of modest size.[18] This reflects the fact that intentional torts are for the most part avoidable torts, and are therefore almost always avoided by reasonable people. If juries do their work well, litigated intentional torts involve behavior that, like violent crime, society need have little fear of overdeterring. This suggests that when punitive damages are restricted to core cases of intentional harm (or intentionally negligent behavior), they can provide useful deterrence without imposing large costs.

B. Nonintentional Torts

The theory of deterrence in tort law has been well examined in the theoretical literature.[19] The general implication is that a well-crafted system of compensatory damages payments and an appropriate set of legal rules can achieve approximate efficiency with respect to pecuniary

[18] Landes & Posner, *Economic Structure of Tort Law* at 302-07 (cited in note 9), concluded that as of the mid-1980s, punitive damages were a trivial proportion of total tort damages payments.

[19] Beginning with John P. Brown, *Toward an Economic Theory of Liability*, 2 J Legal Stud 323 (1973). The theory is worked out in detail in Landes & Posner, Economic Structure of Tort Law (cited in note 9); Shavell, *Economic Analysis of Accident Law* (cited in note 9). It is applied to punitive damages in Cooter, *Punitive Damages for Deterrence* (cited in note 12). The theory of damages multipliers in tort liability law is reviewed and extended in Richard Craswell, *Damage Multipliers in Marketing Relationships*, 25 J Legal Stud 463 (1996).

harms. If there is some probability that the harmful act will not be detected, then multiplied damages may be useful, where the multiplier is the inverse of the probability of detection. We will not re-examine that theory here except to note that for nonintentional torts, market forces (including reputational losses), regulation and compensation for financial losses through the tort system provide sufficient deterrence (and possibly over-deterrence in many situations).[20]

Nonetheless, some scholars advocate punitive damages for nonintentional torts. Their primary justification is that punitive damages can be used to correct for inadequate compensatory damages. Their reasoning is that punitive damages are needed because compensatory damages awards often do not fully compensate for pain and suffering and that a substantial fraction of compensation (typically one-third) goes to attorneys.[21] Even when such reasoning is not explicitly the justification for punitive damages, the effect of punitive damages is largely to supplement the compensation provided by ordinary damages. Thus the effect of punitive damages is to amplify compensation (since damages are paid to victims), and to enlarge its effects.

We believe the goal of using punitive damages to enhance the compensation role of tort law is a bad one. One reason is that punitive damages are far less predictable than compensatory damages. The random nature of punitive damages is vividly illustrated by the BMW litigation in Alabama (where Gore won punitive damages but a similarly situated claimant did not[22]), and by the litigation described below surrounding breast implants and Bendectin. Punitive damages and the concomitant uncertainty strongly affect the litigation process. More cases will be filed because of the chance of obtaining an award that exceeds the level of compensatory damages. These additional cases impose costs. They also serve as a force for changing the law itself in often undesirable ways, as they may lead to inefficient precedents.[23] Moreover, once filed, cases involving extraordinary damages are less likely to be settled and more likely to be litigated than others. While it is possible to calculate the value of compensatory damages with reasonable

[20] See John R. Lott, Jr., *The Level of Optimal Fines to Prevent Fraud When Reputations Exist and Penalty Clauses are Unenforceable*, 17 Managerial & Decision Econ (1996); Calfee & Rubin, *Indicting Liability* (cited in note 10).

[21] See, for example, John A. Sebert, Jr., *Punitive and Nonpecuniary Damages in Actions Based Upon Contract: Toward Achieving the Objective of Full Compensation*, 33 UCLA L Rev 1565 (1986).

[22] See *Yates v BMW of North America, Inc.* 642 So2d 937 (Ala 1993).

[23] As discussed in Rubin & Bailey, *The Role of Lawyers* (cited in note 6).

precision, the value of punitive damages is highly uncertain. This uncertainty makes litigation more likely and settlement less likely, again raising costs.[24]

A second and more fundamental reason for objecting to the use of punitive damages to enhance compensation is that the system has already moved toward providing inefficiently high levels of compensation (i.e., more compensation than product purchasers are willing to pay for in the form of liability insurance). Roughly half of liability payments are for nonpecuniary losses such as pain and suffering or loss of pleasure. It is well known that compensation for nonpecuniary damages creates serious problems for the tort system.[25] As the probability of such damages payments increases, market forces will lead to price increases to compensate for the expected cost to the firm of the payments. These nonpecuniary damages act like an insurance policy for injured or deceased consumers, and in both cases the marginal value of wealth (net of compensatory damages, comprising mainly replacement income and medical costs) is usually reduced.

Thus, the insurance has the effect of taking money away from situations where it is more valuable in order to provide more money where it is less valuable. The insurance is therefore valued by consumers at less than its costs, and the net effect is to distort prices and reduce consumer welfare by forcing consumers to buy undesired insurance bundled with products and services. Punitive damages awards, which are often (although not in the *Gore* case) awarded on top of pain and suffering awards, exacerbate these effects. Even when they are awarded in situations that do not involve pain and suffering (and thus do not immediately raise the issue of unwanted insurance), punitive damages are at best a lottery for consumers with extremely high load fees (in the form of legal fees).

Unfortunately, the adverse dynamics of pain and suffering awards, amplified by punitive damages awards, tend to focus on products and services (such as pharmaceuticals and medical care) that are designed to reduce consumer risk. In particular, punitive damages tend to be attractive to juries where there is great harm to consumers, but often that harm simply reflects the

[24] Robert D. Cooter and Daniel L. Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution,* 27 J Econ Literature 1067 (1989).

[25] The points in this paragraph are laid out in greater detail in John E. Calfee and Paul H. Rubin, *Some Implications of Damage Payments for Nonpecuniary Losses*, 21 J Legal Stud 371 (1992); Paul H. Rubin, *Tort Reform by Contract* (AEI, 1993); and Calfee & Rubin, *Indicting Liability* (cited in note 10).

remaining risk left over after the product under attack has reduced consumer risk below its original level. Expansive pain and suffering and punitive damages awards then increase the price of risk-reducing products to cover the cost of large insurance policies that are worth less than their costs. Moreover, the prospect of punitive damages interacts with other aspects of the liability system such as joint and several liability (which pulls in suppliers of materials and components) and fraudulent medical expenses generated by incentives to inflate costs. The effect is to push consumers away from risk-reducing products and toward unnecessary risk. Indeed, many discussions of the effects of expanded liability treat pain and suffering and punitive damages awards as having the same general effects.[26]

For the reasons just outlined, we conclude that punitive damages are likely to harm consumer welfare when they are extended beyond their traditional role of deterring intentional torts and intentional negligence.

C. The Consequences of Muddling the Distinction between Intentional and Nonintentional Torts

If punitive damages are limited to intentional torts, they are certain to be rare and are unlikely to inflict significant harm on the economy. There is ample evidence, however, that courts are countenancing an expansion of punitive damages beyond intentional torts.[27] In California, punitive damages came to account for almost half the value of tort damages in employee dismissal cases by the late 1980s.[28] In some parts of Alabama, where the *Gore* case arose, efforts to obtain punitive damages have become common in liability suits, with claims typically involving routine traffic accidents, insurance disputes, and employee dismissals.[29] There is no reason to think these trends are simply the product of a sudden surge in the intentional infliction of tortious harm. Other data, reviewed in Part II.D below, also suggest that

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[26] See, for example, Peter W. Huber, *Liability: The Legal Revolution and Its Consequences* 115-32 (Basic Books, 1988).

[27] Much of the recent academic disputes over punitive damages has focused on whether such an expansion is a good thing, while taking for granted that punitive damages have moved beyond intentional torts. See, for example, the special issue on punitive damages in volume 40 of the *Alabama Law Review* (1989).

[28] James N. Dertouzos, Elaine Holland, and Patricia Ebener, *The Legal and Economic Consequences of Wrongful Termination* (RAND Institute for Civil Justice, 1988).

[29] George L. Priest, *Statement on H.R. 10, "Common Sense Legal Reform Act of 1995,*" Testimony before the Committee on the Judiciary, U.S. House of Representatives (Feb 13, 1995) ("Priest, *Statement on H.R. 10*").

punitive damages awards are far more common than in earlier decades, and moreover, that their effects in the marketplace may vastly exceed the amounts actually awarded and upheld on appeal.

What appears to be changing is not the behavior of tortfeasors, but judicial standards for punitive damages. The manner of change is not always obvious. In the Bendectin and breast implant cases, discussed below, the main issue is causation. Most juries say the product did not cause the putative harm; but on the few occasions when juries do find for the plaintiff, they tend to award huge punitive damages. The juries' reasoning seems to be that the product was administered to victims intentionally, that the manufacturers knew as much as anyone else that harm was possible, and that the harm caused by the product was therefore intentional. The effect is to expand the concept of intentional torts to include some forms of negligence (assuming the product did in fact have the asserted effect). This enlarged notion of intentional harm can make punitive damages nearly useless as a part of the tort system. It provides no safe harbor for efficient behavior, which inevitably must sometimes involve negligence.

A separate factor--one that has traditionally led to punitive damages-- is a tortfeasor's effort to conceal a tort that would otherwise not justify an award beyond compensatory damages. Under certain circumstances, this is an appropriate role for punitive damages. In the typical tort, where the offender is known, the probability of detection is one and there is no need for multiplied damages. If the tortfeasor makes an effort at concealment, however, this effort will sometimes be successful, and so some concealing tortfeasors will not be penalized. For injurers attempting concealment, multiplied damages are useful for efficient deterrence. Punitive damages could therefore serve to move damages payments closer to an optimal level (although as we noted earlier there is little reason to think juries will actually set awards to imitate multipliers).

This assumes, however, that concealment involves the kind of intentional behavior that characterizes intentional torts, and that firms can therefore avoid punitive damages by engaging in efficient behavior (including efficient disclosure of information) that still leaves room for ordinary negligence (for which punitive damages are not appropriate). But the notion of concealment can be combined in a very unfortunate manner with the expanded idea of intentionality just discussed. For example, if mere knowledge of risk tradeoffs is taken to demonstrate an intent to conceal, then manufacturers could easily be found guilty of concealment

by intent. Manufacturers of potentially injury-causing products such as automobiles will almost of necessity generate documents measuring the risk. No manufacturer could publicize all of these documents, which typically contain preliminary estimates that turn out to be erroneous along with crude estimates of myriad potential harms associated with reasonable tradeoffs. If the existence and nondisclosure of such documents becomes evidence of concealment, and therefore the basis for punitive damages, then again the system will not operate properly. Firms would be subjected to unlimited damages for efficient behavior. Moreover, the fact that firms could not predict which of a multitude of nondisclosures would give rise to such exposure to liability means that the threat of punitive damages would do little to improve the information environment.

This analysis implies that the prospect of punitive damages can overdeter useful activities. The goal of the liability system is to deter clearly inefficient acts, without deterring the socially useful behavior that may occasion such acts. The danger of punitive and other unreasonably large damages payments is that they can serve to deter useful and productive activities by making it impossible for firms behaving efficiently to avoid unlimited damages payments.

In considering this issue, a distinction made by Elliott, between "general or class predictability" and "specific or act predictability" is useful.[30] By the former, he means that one can foresee "the incidence of some consequence as a result of engaging in a class of activity" as opposed to "the ability to predict which of the specific actions within the class are likely to give rise to the consequences." In other words, with respect to punitive damages, a firm can sometimes predict the existence of punitive damages for something that it will do, but it cannot always predict what specific action will induce the damages. In this world, a firm must increase the prices it charges to cover the expected damages payment, but it cannot modify its behavior in a meaningful way because it cannot determine which act will lead to the damages.

The key to Elliott's analysis is the second point. Is it true that firms are sometimes unable to predict which particular actions will lead to punitive damages?[31] We discuss this issue below. But we note that it may actually be worse: firms may sometimes be able to predict that they will

[30] E. Donald Elliott, *Why Punitive Damages Don't Deter Corporate Misconduct Effectively*, 40 Ala L Rev 1053, 1057 (1989).

[31] Michael Wells criticizes Elliott on other grounds in Comments on *'Why Punitive Damages Don't Deter Corporate Misconduct Effectively,'* 40 Ala L Rev 1073 (1989).

be liable for punitive damages for socially useful conduct, so that the threat of punitive damages itself may actually deter desirable behavior. That is, the marginal behavior associated with punitive damages may itself be useful, so that even if damages serve a clear deterrence function, they will be harmful.

Consider Wheeler's discussion of design standards.[32] He points out that any consideration of risk in product design can later be interpreted by a jury as evidence that the firm knew it was producing a risky product and "traded profits for lives." To the extent that risk analysis is deterred by the threat of punitive damages, then predictability itself can actually be harmful. Firms will avoid making cost-benefit or other rational calculations in order to avoid liability. This point is illustrated in the Bendectin litigation, discussed below.

These issues are reminiscent of a famous debate in law and economics. Becker and Stigler proposed increased reliance on private enforcement of law.[33] However, Landes and Posner pointed out that the criminal law system worked through a system of high penalties and low probabilities of conviction, which would not survive private enforcement.[34] If private parties were able to retain the multiple damages associated with low probabilities of conviction, there would be incentives for over-investment in enforcement activities and thus, overdeterrence. This is in fact what is happening as a result of private litigation through the tort system.

D. Market Effects of Punitive Damages Awards[35]

The sketchy available data on punitive damages suggest that awards have multiplied in recent decades, but their total remains small relative to the liability system as a whole. Data from the ongoing study of San Francisco, California and Cook County, Illinois, conducted by the RAND Institute for Civil Justice, indicate that total punitive damages awards for all tort cases in those counties increased from approximately $1 million dollars during the years 1960-1964, to $147 million during 1985-1989 and $215 million during 1990-1994 (an average of about $50 million annually). Other, less systematic data also indicate a strongly upward trend, bearing in

[32] Malcolm E. Wheeler, *A Proposal for Further Common Law Development of the Use of Punitive Damages in Modern Product Liability Litigation*, 40 Ala L Rev 919 (1989).

[33] Gary S. Becker and George J. Stigler, *Law Enforcement, Malfeasance, and Compensation of Enforcers*, 3 J Legal Stud 1 (1974).

[34] William M. Landes and Richard A. Posner, *The Private Enforcement of Law*, 4 J Legal Stud 1 (1975).

[35] This discussion is drawn from Calfee & Rubin, *Indicting Liability* (cited in note 10).

mind substantial uncertainty about the extent to which jury awards are overturned on appeal.[36]

There are reasons to think that punitive damages awards could rapidly accelerate as claims for punitive damages become common (rather than being rarely sought, as was once the case). In some parts of Alabama, attorneys now claim punitive damages in nearly all tort suits. An Alabama jury recently awarded $50 million in compensatory damages and $100 million in punitive damages for a single injury in which causation by a product defect seems to have been quite dubious.[37] (*Gore* will of course tend to restrain punitive damages, but whether it will have an effect on personal injury cases, as opposed to cases involving only economic injury, remains to be seen.)

Far more important than the total of actual awards are the indirect effects that the threat of punitive damages can have on settlement negotiations and on decisions about marketing, production, and entry into or exit from markets. There can be no doubt that once punitive damages have been awarded for particular products in specific jurisdictions, the possibility of additional awards can dominate pre-trial negotiations and settlement amounts. Data on punitive damages actually awarded are therefore deceptive because they omit amounts paid when firms settle out of court, and of course they also omit the overdeterrence that occurs when firms withdraw from markets altogether rather than face the possibility of further punitive damages awards.

The gap between data on court awards and actual market effects is evident from two legal episodes, one concerning breast implants and the other concerning the anti-nausea drug Bendectin. Silicone breast implant litigation began slowly. The first recorded verdict was handed down in 1977, and the first punitive damages award (for $1.5 million) occurred in November

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[36] The data are from Deborah Hensler and Erik Moller, *Tends in Punitive Damages: Preliminary Data from Cook County, Illinois and San Francisco, California,* (RAND Institute for Civil Justice unrestricted draft series, March 1995) (DRU-1014-ICJ). For a sample of the continuing debate over trends in punitive damages, see Martin F. Connor, *The State of the Punitive Damages Debate: 1993,* 8 Toxics L Rptr 357 (BNA, Aug 25, 1993); Thomas Koenig, Michael Rustad, and Robert Granfield, *The Myth of the Punitive Damages Explosion: A Response to Martin F. Connor*, 8 Toxics L Rptr 703 (BNA, Nov 17, 1993).

[37] Priest found that for two rural Alabama counties during the fiscal years 1992-1993 and 1993-1994, the percentage of tort cases in which punitive damages were claimed ranged from 65% to 95%. Priest, *Statement on H.R. 10* (cited in note 29). The recent personal injury verdict, which was handed down in one of the counties studied by Priest, involved Chevrolet vehicles. See Gabriella Stern, *GM Assessed $150 Million by Jury in Crash Case,* Wall Street Journal A2 (June 4, 1996).

1985. Sixteen cases had reached verdict by the end of 1991, mostly for plaintiffs, yielding about $32 million in damages including $15 million in punitives, while Dow Corning, the largest manufacturer, faced 137 additional lawsuits.[38] Litigation accelerated very rapidly after January 1992, when the FDA declared a moratorium on silicone breast implants: lawsuits against Dow Corning alone increased to 3,558 by the end of the year, and reached 12,359 a year later.[39] Medical data at the time of the FDA moratorium, however, failed to reveal a systematic connection between breast implants and the illnesses at issue. Eventually, epidemiological data largely ruled out any such connection.[40]

Nonetheless, the leading breast implant manufacturers proposed a class action settlement in September, 1993. A settlement was approved by the court in April 1994 for a total amount of $4.25 billion. Plaintiffs' attorneys, however, encouraged clients to opt out of the settlement and pursue individual lawsuits. The number of lawsuits against Dow Corning continued to increase, reaching 19,092 by the end of 1994. In May 1995, Dow Corning declared bankruptcy.[41]

The disparity between data on jury awards and the market effects of punitive damages could

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[38] The 1977 case is described in Joseph Nocera, *Fatal Litigation,* Fortune 60 (Oct 16, 1995); the appellate case is reported by Bristol-Myers Squibb as *V. Mueller & Co. v Corley,* Texas (finding against Dow Corning and upholding the $170,000 verdict). The other data are drawn from Bristol-Myers Squibb Public Affairs and Public Broadcasting System, *Frontline: Breast Implants on Trial: Chronology of Silicon Breast Implants,* (PBS 1996) (available at http://www.boston.com:80/wgbh/pages/frontline/implants/cron.html) ("Public Broadcasting System, *Frontline*"). Details are provided in Calfee & Rubin, *ndicting Liability* (cited in note 10).

[39] Bruce Ingersoll, *Firms Are Asked to Stop Selling Breast Implants,* Wall Street Journal B1, B5 (Jan 7, 1992); Jack C. Fisher, *Sounding Board: The Silicone Controversy: When Will Science Prevail?,* 326 New England J Medicine 1696 (June 18, 1992); David Kessler, *Special Report: The Basis of the FDA's Decision on Breast Implants,* 326 New England J Medicine 1713 (June 18, 1992). Kessler was Commissioner of the FDA.

[40] The Executive Editor of the *New England Journal of Medicine* was sharply critical of the FDA decision and of the liability system's treatment of breast implants. See Marcia Angell, *Breast Implants: Protection or Paternalism?,* 326 New England J Medicine 1695 (June 18, 1992); Marcia Angell, *Science on Trial: The Clash of Medical Evidence and the Law in the Breast Implant Case* (W.W. Norton & Co, 1996). For a similar view from the U.K. medical device regulatory authority, see D.M. Gott and J.J.B. Tinkler, *Silicone Implants and Connective Tissue Disease: Evaluation of Evidence for an Association between the Implantation of Silicones and Connective Tissue Disease: Data Published from the End of 1991 to July 1994* (UK Department of Health, Medical Devices Agency, Dec 1994). Much of the recent research is summarized in Angell's book. The two most recent large-scale epidemiological studies are Jorge Sanchez-Guerrero, et al, *Silicone Breast Implants and the Risk of Connective Tissue Diseases and Symptoms,* 332 New England J Medicine 1666 (June 22, 1995); Charles H. Hennekens, et al, *Self-Reported Breast Implants and Connective-Tissue Diseases in Female Health Professionals: A Retrospective Cohort Study,* 275 J Am Medical Assoc 616 (Feb 28, 1996).

[41] Data and details from Public Broadcasting System, *Frontline* (cited in note 38).

hardly be sharper. Implant manufacturers offered a $4.25 *billion* settlement at a time when they had lost only 15 verdicts (with thousands of suits pending) yielding a total of $57 million in damages, including $35.5 million in punitives. When Dow Corning entered bankruptcy a year later, the industry had been assessed damages of $30 million, including $25 million in punitive damages--a level that was actually considerably *less* than it was a year earlier when the class action settlement was approved by the courts--and Dow Corning itself had lost only 6 verdicts.

Clearly, a simple accounting of verdicts and damages fails to convey the impact of breast implant litigation. The record pointed to a distressing future. A handful of adverse verdicts, with virtually no support in medical science, had yielded tens of millions in compensatory and punitive damages. It is true that as science has turned more strongly in support of the defense, plaintiffs have lost most cases. Only nine of 22 verdicts since the moratorium have favored plaintiffs. But total awards in these nine post-moratorium losses were nearly $92 million, including four punitive damages awards of about $48.5 million--an average of $4.2 million including $2.2 in punitive damages per verdict, win or lose.[42] Some of these awards were reversed or reduced on appeal. But even a small probability of a final adverse verdict for each case adds up to unsustainable losses over the course of defending tens of thousands of suits.

Very different facts have yielded similar lessons in the case of Bendectin, which is the only FDA-approved drug for morning sickness during pregnancy. Bendectin has been under attack since 1977 as a cause of birth defects despite a lack of scientific evidence for such a connection. The drug, which has no patent protection, was removed from the market in 1983 immediately after the first adverse liability verdict, for $750,000 in compensatory damages. On June 24, 1984, the more than 700 cases outstanding were consolidated into a mandatory class action, and one month later the manufacturer, Merrell Pharmaceuticals, offered a settlement fund of $120 million. The class consolidation was challenged and dissolved on appeal in October 1984. More than ten years later, in February 1995, the class action was made voluntary, with over 1,100 claimants signed up, while additional actions continued outside the class.

Forty-four Bendectin cases have reached verdicts. Forty-one favored the manufacturer (some still under appeal). The three favoring the plaintiffs are under appeal and involved a total of more than $40 million in punitive damages. In addition, seven verdicts resolved in favor of the

[42] Data from Bristol-Myers Squibb Public Affairs.

manufacturer initially assessed damages totaling over $150 million, including a $75 million punitive damages judgment handed down in 1987 and overturned three years later.[43]

The role of punitive damages in Bendectin litigation is striking. A leading analysis of products liability suits noted that "by 1993, courts generally had adopted the position that the plaintiffs' experts and their scientific evidence could not support a finding that Bendectin causes birth defects."[44] Nonetheless, litigation continues and the few plaintiff verdicts yield immense punitive damages. Almost all punitive damages are overturned on appeal, so that a survey of punitive damages would find perhaps $10 million in punitives with a much larger number having fallen to appeals. But Bendectin remains off the market despite there being no alternative treatment for a serious condition, because a favorable science base has not afforded the manufacturer protection against the possibility of unlimited damages awards by a few juries.

The breast implant and Bendectin episodes suggest that punitive damages have expanded beyond intentional torts, and in so doing can easily distort markets. When highly similar circumstances (the same product from the same manufacturer taking the same actions with the same knowledge and intentions) yield utterly contradictory jury verdicts, one would think that the actions under scrutiny cannot have approached the egregious types of behavior that have been the traditional subject of punitive damages. In the case of breast implants, juries often find for the defendant (more often than not, in recent years). But when they find for the plaintiff, they tend to provide expansive compensatory awards and then tack on large punitive awards. With Bendectin, the verdict is almost always for the manufacturer, but again, plaintiff verdicts yield huge punitive damages. What appears to be happening is this: when juries decide the causation issue (did the implants cause the symptoms, or did Bendectin cause the birth defect?) they

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[43] On the health effects of Bendectin, see Louis Lasagna and Sheila R. Shulman, *Bendectin and the Language of Causation,* in Kenneth R. Foster, David E. Bernstein, and Peter W. Huber, eds, *Phantom Risk: Scientific Inference and the Law* 101 (MIT Press, 1993). Our account draws on Peter W. Huber, *Galileo's Revenge: Junk Science in the Courtroom* 117-121 (Basic Books, 1991), and on information from the Legal Department at Hoechst Marion Roussel, which is the successor firm to Merrell Pharmaceuticals. The 1983 verdict was Oxendine v Merrell Dow Pharmaceuticals, (Washington, DC, May 27, 1983). The $75 million punitive damages case was *Ealy v Richardson-Merrell, Inc.* (District of Columbia, 1987) (described in Huber, *Galileo's Revenge* at 122). The Texas case is *Havner v Richardson-Merrell, Inc.* The case in which additional punitive damages were awarded is *Blum v Richardson-Merrell,* originally tried in 1987 in Pennsylvania.

[44] Deborah R. Hensler and Mark A. Peterson, *Understanding Mass Personal Injury Litigation: A Socio-Legal Analysis,* 59 Brooklyn L Rev 961, 980 (1993).

immediately expand an affirmative finding on causation into a finding of reckless or intentional infliction of harm. The effect is that punitive damages, which were designed as an extreme option for unusual cases, become an instant multiplier of compensatory damages. Litigation exposure becomes uncontrollable.

The upshot is that even a small probability of an unlimited loss is sufficient to force manufacturers out of a market, to provoke extraordinarily generous multi-billion dollar settlement offers, and even to force a large firm into bankruptcy. Clearly, data on final judgments alone cannot tell us much about the market impact of punitive damages. The events just reviewed occurred in markets where a tally of punitive damages awards would total less than $100 million, including awards still under appeal. One could hardly imagine a clearer example of how punitive damages data alone fail to suggest the actual effects of punitive damages awards. What counts are expectations of the future, based on such matters as the relationship between injury and magnitude of punitive damages awards and the apparent willingness of juries to assume wanton or reckless behavior. One awaits the effects of *Gore* on these issues.

III. PUNITIVE DAMAGES IN *BMW V GORE*

BMW v Gore illustrates many of the points just outlined. First, there is overdeterrence. No one wants BMW to stop selling cars in Alabama. Nonetheless, BMW stopped selling new cars in Alabama that had been repaired. That is, rather than disclose repairs, the company reduced the number of cars available for sale in Alabama.

Second, the case involved what would normally be considered a nonintentional tort. To the extent that the jury believed that BMW's conduct was an intentional tort, this illustrates how the concept of an intentional tort has been so far stretched beyond its original meaning that the economic benefits of punitive damages have been swamped by the economic harm that is bound to follow.

Third, BMW could not reasonably have expected that the particular act in question (failing to disclose minor paint repairs) would lead to massive punitive damages. In its opinion, the Supreme Court makes clear that there was no reason to expect any such effect. Many states required disclosure of repair efforts, but the statutory threshold was 3% of the value of the automobile, the same as BMW's policy. The Court indicated that “a corporate executive could

reasonably interpret these disclosure requirements as establishing safe harbors."[45] Alabama imposed a maximum penalty for violation of the Deceptive Trade Practices Act of $2,000. Thus, there is no way in which a rational company could have foreseen and avoided this particular instance of massive punitive sanctions. In Elliott's terms, it was unpredictable that the specific act would lead to punitive damages.

Fourth, although the Alabama decision in *Gore* may have put automobile companies on notice that they must inform consumers about paint repairs, that left open the possibility that a jury in Alabama (or elsewhere) could find some automobile manufacturer liable for massive punitive damages for some act now considered routine.[46] Thus, verdicts such as the original state court decision in this case create or contribute towards fear of "general or class" liability and so increase costs and prices to consumers.

Fifth, BMW would have had no reason to disclose that the car had been repainted. Since such a policy was considered normal business practice and was legal in all states that had explicitly considered the issue, there was no way that the firm would anticipate that a failure to disclose would be considered fraud.

Sixth, the court record indicates that approximately 1,000 buyers nationwide have purchased repainted cars, and 14 of these are in Alabama. Depending on when these cars were purchased and the relevant statutes of limitations, some or all of these purchasers could also sue for $2 million or $4 million in punitive damages; absent the Supreme Court decision, there would have been nothing to stop them. Thus, the damages payments could easily have been leveraged into even more massive costs were it not for the Supreme Court's decision.

Finally, an important motive for bringing such a case was the hope of punitive damages. The

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[45] 116 S Ct at 1600.

[46] It has been said that cars made on Mondays are more likely to be defective since workers were recovering from the weekend. Is it beyond the realm of possibility that a jury would find a manufacturer liable for not disclosing the day of manufacture? At one time the FTC had a "defects" program, which essentially found manufacturers liable for failure to disclose that any component of a car was below average in durability for that component for all cars. Massive revenues for Alabama tort lawyers! The state of California has recently indicated that it believes that Chrysler has sold 116 cars in violation of the state "lemon law." (Reuter News Release, May 31, 1996.) Are each of the buyers of these cars entitled to millions of dollars in punitive damages? As we write this, an Alabama jury has awarded $50 million in compensatory and $100 million in punitive damages against General Motors to an injured driver (who was not even wearing a seat belt) thrown from a car because of alleged substandard door latches in Chevy Blazers. Gabriella Stern, *GM Assessed $150 Million by Jury in Crash Case,* Wall Street Journal A2, A4 (June 4, 1996).

chance of punitive damages also provided incentive for litigation rather than settlement. It is unlikely that anyone would have litigated a case (to the Supreme Court!) for $4,000.

One issue that was *not* relevant in this case is safety. The court mentioned specifically that Gore's loss was "purely economic" and that "BMW's conduct evinced no indifference to or reckless disregard for the health and safety of others."[47] This leaves the impression that the Court is more likely to uphold punitive damages when personal injury is involved. As discussed above, however, there is a real danger in allowing excessive damages in personal injury cases, particularly for risk-reducing products. We would expect many personal injury cases to involve risk-reducing products for reasons mentioned above. It will be important to see what the Supreme Court does when it hears a case involving a pharmaceutical or medical device, or a similar matter.[48]

As in previous cases, the *Gore* Court was unwilling to specify the exact level of punitives that will be impermissible. Three factors were considered in deciding that damages were excessive (although Justice Scalia's dissent pointed out that the opinion did not rule out the possibility that other factors could be brought to bear in future decisions). First was the "degree of reprehensibility" of the act. It was here that the Court noted that the loss was "purely economic" and did not involve threats to health and safety. The second factor was the ratio between compensatory and punitive damages, although the Court was unwilling to accept a "simple mathematical formula." The third factor was the level of statutory or other sanctions for comparable misconduct.

The Court could have used economic reasoning to make the results of the *Gore* decision more precise. The unwillingness to establish a "mathematical formula" may interfere with applying deterrence theory to calculate damages based on the probability of detection, the standard economic approach to setting the level of damages needed to deter acts in situations where the probability of detection is less than one. Indeed, in his concurring opinion Justice

[47] 116 S Ct at 1592.

[48] After deciding *Gore*, the Supreme Court considered a petition for certiorari in *Honda v Oberg*, a case involving personal injury on an All Terrain Vehicle. As discussed below, the Supreme Court had previously sent this case back to the Oregon courts for procedural reasons. However, the Oregon Supreme Court reheard the case and ruled that the original level of damages was not excessive, and the United States Supreme Court did not grant certiorari a second time.

Breyer did mention Shavell[49] and Cooter,[50] who have argued theoretically for such an approach, in discussing the economics of punitive damages.[51] Such measures are not strangers to the legal system; they are explicitly used in the Sentencing Guidelines of the United States Sentencing Commission,[52] and of course Justice Breyer was a Commissioner before his appointment to the Supreme Court. In *Gore,* the record indicates that 14 Alabama consumers lost $4,000 each. If so, total losses for Alabama consumers are $56,000. This level of punitive damages would exactly offset any putative gains to BMW from its conduct and thus provide whatever deterrence is needed.[53]

IV. FEDERALISM

The argument so far is that the Supreme Court decision to set aside punitive damages in Gore was efficient once the Court decided to hear the case. However, in two separate dissents, Justice Scalia (joined by Justice Thomas) and Justice Ginsburg (joined by Chief Justice Rehnquist) raised a preliminary issue: was it appropriate for the Supreme Court to address the issue at all? Tort damages are traditionally a state function, so federalism questions are appropriate. We will first discuss the general topic of federalism and punitive damages, and then the specific application to the case at hand. There are two issues. One is legal: does the Constitution allow for federal review of state court damages findings? The second is economic: should the federal courts review state court findings of damages? We concentrate on the economics of the issue.

The most powerful argument for federalism is Tiebout's: if residents of a local governance

[49] Shavell, *Economic Analysis of Accident Law* (cited in note 9).

[50] Cooter, *Punitive Damages for Deterrence* (cited in note 12).

[51] Breyer also refers to *Browning-Ferris,* indicating that "the Constitution 'does not incorporate the views of the Law and Economics school.'" *Gore,* 116 S Ct at 1608 (Breyer, concurring).

[52] Although not correctly. Compare Jeffrey S. Parker, *Criminal Sentencing Policy for Organizations,* 26 Am Crim L Rev 513 (1989 with Jeffrey S. Parker, *Rules Without… Some Critical Reflections on the Federal Corporate Sentencing Guidelines,* 71 Wash U L Rev 397 (1993).

[53] We assume that the consumer loss equaled or exceeded BMW's gain. We also note that nationally, there were about 1,000 consumers affected. However, both the Alabama Supreme Court and the United States Supreme Court found that it was improper to penalize BMW for harm to non-Alabama consumers. Indeed, it was for this reason that the Alabama Supreme Court reduced the damages from $4,000,000 to $2,000,000. Why they chose $2,000,000 rather than $56,000 is a puzzle the United States Supreme Court did not address.

area do not like the policies of the government, they can move to a jurisdiction whose policies they like better.[54] In other words, if the courts in a local jurisdiction err, and if the costs and benefits are borne locally, residents can respond locally. This framework can determine the efficient scope of decision making.

A. Federalism in the *Gore* Dissents

The four dissenters in *Gore* were reacting to the most radical aspect of the decision. Henceforth, all punitive damages awards in state and federal courts must comply with due process standards that will ultimately be developed by the federal courts. The dissenters, in two separate opinions, gave several reasons for opposing the federalization of punitive damages awards.

Justice Scalia, joined by Justice Thomas, emphasized that the traditional purpose of punitive damages has been to express the community's sense of outrage or indignation about a particular practice. The Court's decision regulates these community judgments and thus transfers power from local communities to the Supreme Court. Justice Scalia found no basis for this federal role in either the text or the history of the Fourteenth Amendment (whose due process clause applies to state action), and he found no basis for the *Gore* result in the Court's own precedents. Justice Scalia also criticized the majority for failing to provide clear standards for state courts to use when assessing whether particular punitive damages awards are so large that they violate due process. Indeed, he suggested that these standards would be impossible to develop.

Justice Ginsburg, with Chief Justice Rehnquist, also emphasized the difficulty of developing federal punitive damages standards and noted the Court's own reluctance to regulate the size of jury verdicts in federal cases, which seems inconsistent with the path taken by the majority. She also stressed that many states have recently regulated punitive damages awards and that many others are considering legislation designed to do so. These legislative solutions, she argued, would be partly preempted by the Court's *Gore* decision, and she said that this preemption was unwise both because local action was best and because the regulation of punitive damages was better accomplished by legislatures than by courts. For instance, legislation often takes the form of bright-line rules (punitive damages cannot exceed, say, four times actual damages), whereas courts find it difficult to implement standards of this type.

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[54] Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J Pol Econ 416 (1956).

Nevertheless, the jury award in *Gore* seems troubling. In order to award punitive damages against BMW, the jury had to find that BMW had committed a fraud that was "gross, oppressive, or malicious," which was the Alabama state-law standard upon which the jury was instructed. Given BMW's position in the market, it might seem unlikely that it would base its business on fraud that was "gross, oppressive, or malicious." After all, BMW seeks repeat purchases from consumers who are especially concerned with high quality. It is possible that the jury merely thought that BMW's conduct amounted to fraud when in fact it represented a reasonable response to acid rain and the difficulty of explaining to consumers the benefits of accepting a chance that an automobile has been repainted. Whether BMW's conduct in this particular case was fraudulent or efficient, it is clear that Alabama juries are free to award punitive damages for conduct that truly is efficient. In many contexts, and the *Gore* case itself affords a good example, it is difficult to tell the difference.

B. A Theory of Federal Regulation of State Damages Awards

Assume that courts in some jurisdiction-say, Alabama-begin to impose punitive damages for conduct that does not invite punitive damages in other states. This could happen for several reasons. First, the beliefs of judges or citizens in Alabama about the relationship between punitive damages awards and such matters as safety may differ from what citizens of other states believe. If Alabamians are right, other states can learn and adapt their laws accordingly. This is one of the justifications for federalism, and no Supreme Court or other national action to change this policy is needed. Second, Alabama voters and citizens may have different preferences than citizens of other states. They may, for example, put a higher value on non-repainted cars or safer door latches (perhaps because they prefer not to wear seat belts) than others do. Again, this is a standard rationale for leaving discretion in the states under the principles of federalism.

Third, the citizens of one state may make more errors in characterizing business conduct as fraudulent than do the citizens of other states, perhaps because of differences in the level and quality of the educations they have received. Uneducated people sometimes mistake the normal workings of the marketplace for fraud. During the oil crisis of the 1970s, many people thought that it was fraudulent for the oil companies to increase their prices of current stocks of petroleum, which the oil companies had been able to purchase before OPEC increased its prices. Although immediate price increases were necessary to allocate newly scarce supplies, many saw them as fraudulent. Finally, and most likely, attorneys or other special interest groups may be in

a stronger position in Alabama than in other places, so that they are better able to engage in successful "rent seeking," i.e., using the law to establish market power for favored parties.[55] This would be unfortunate, but it does not in itself justify federal intervention. States pass all sorts of special interest legislation with which the federal government does not (and should not) interfere.

Whatever inefficiencies such jury decisions may impose on the people of the state where they occur, the mechanism of federalism should place limits on the harm they cause.[56] When a company does business in many states, however, it is possible for the juries of one state to appropriate the wealth of citizens of other states. Part of the value of buying a BMW in Georgia comes from the availability of dealer service in other states, including Alabama. Alabama juries can therefore appropriate some amount from BMW that citizens of other states will bear as a cost. BMW may try to raise prices in Alabama, but this would tend to induce Alabama consumers to purchase their automobiles in neighboring states.[57] Hence, an Alabama price increase could easily become self-defeating for a manufacturer that wished to capture the economies of scope from sales and service in Alabama. In effect, such a manufacturer could find it cheaper to raise prices generally throughout the country, thus ratifying the appropriation by Alabamians of wealth from citizens elsewhere.

It might appear that punitive damages act like a tariff on goods imported from other states. In a sense, however, they are worse. A tariff increases the prices of goods in the duty-levying jurisdiction but reduces prices elsewhere since supply is increased elsewhere. A levy in the form of punitive damages that are unique to a single state increases prices uniformly throughout the country but gives the entire proceeds to citizens of only that one state.

The possibility for interstate appropriation becomes the best reason for the federal regulation of punitive damages. When such appropriation is possible, the Tiebout argument cannot come into play because there is no way for citizens of one state to protect themselves by migration. When the possibility of this appropriation does not exist, there is little justification for federal

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[55] Rubin & Bailey, *The Role of Lawyers* (cited in note 6).

[56] Tom Campbell, Daniel P. Kessler, and George B. Shepherd, *The Causes and Effects of Liability Reform: Some Empirical Evidence* (National Bureau of Economic Research, Working Paper 4989, Jan 1995), argue that the costs of inefficient jury verdicts have primarily local effects.

[57] Also discussed in Michael W. McConnell, *A Choice of Law Approach to Products-Liability Reform,* in Walter Olson, ed, *New Directions in Liability Law* 90-101 (Academy of Political Science, 1988).

due process regulation of state punitive damages awards. Indeed, as will be explained below, the current pattern of the Court's punitive damages decisions can be explained by this theory. In particular, the theory suggests that the federal courts would have a role in regulating punitive damages awards when both of the following conditions hold:

1. The transaction that yielded the award must have been a part of interstate commerce in some sense more restrictive than the ordinary legal meaning. Although the Gore Court premised its decision on due process grounds, the best theory of the result comes from the possibility that one state's citizens can appropriate wealth from citizens of other states. If the defendant could easily charge the citizens of the awarding state with all of the costs of an incorrect punitive damages decision, little justification would exist for federal regulation. Hence, services and even products that are provided on an exclusively local basis should be subject to punitive damages awards without federal supervision. With most nationally distributed products, on the other hand, it is costly for the manufacturer to ensure that the citizens of a particular state acquire the product only in ways that do not invoke the jurisdiction of their courts, especially when their courts have long-arm statutes at their disposal. If Alabama juries demonstrate bad judgment in pharmaceutical cases, manufacturers might refuse to sell in Alabama, denying Alabamians drugs that expose the manufacturer to inappropriate punitive damages awards. Middlemen, however, might fill this lacuna by purchasing and reselling drugs in Alabama at a higher cost to compensate for liability, and manufacturers might not be able to escape liability under existing longarm statutes.[58] Such situations provide a strong case for federal supervision of punitive damages as long as federal limitations on long-arm statutes are lax or ambiguous. A weaker case might entail a transaction involving a Birmingham plumber or used car dealership. If it is a case in which Alabamians exercise bad judgment for themselves, it is reasonable to rely upon Alabama institutions to regulate their excesses. Nevertheless, Alabamians may be encouraged to exercise bad judgment by the knowledge that other American citizens will

[58] One can envision wholesalers going into business in Georgia for the sole purpose of selling to retailers in Alabama. Prices would be higher in Alabama because the wholesaler would be liable for Alabama damages, but the manufacturer would not be liable if refusals to sell directly in a state could insulate manufacturers from personal jurisdiction in that state. Alabamians would still be able to purchase goods cheaper in Georgia or elsewhere if they were willing to undertake the costs of travel. However, either option would cost Alabamians money, as is appropriate if they choose to have odd laws. But, as discussed below, under current law it is not clear that the manufacturer would escape liability under this arrangement.

bear some or most of the cost. Indeed, in this situation, they might deceive themselves that their policy really benefits everyone equally.

2. It is impossible for the defendant to charge the citizens of the state with the total value of expected bad judgments. Suppose a state frequently awards large punitive damages judgments in inappropriate cases. If firms can easily ensure that the costs of these judgments are charged back exclusively to the citizens of that state, there seems little reason for federal regulation. If Alabama juries acquire a reputation for bad medical malpractice verdicts, for example, it could be relatively easy for physicians and hospitals to increase prices in Alabama or to withdraw from Alabama. Similarly, there seems to be no strong case for federal supervision of punitive damages in connection with land transactions and service transactions. Indeed, it could even be counterproductive for federal courts to reverse bad judgments against physicians, as opposed to cross-border firms such as BMW. It is costly for federal courts to decide cases. If Alabama could rely on outside institutions to correct its own bad judgments, it could partly externalize the cost of decisions that have lead to socially counterproductive results. If Alabamians believe that normal market transactions are fraudulent, there is an argument for allowing them and citizens of other states to see the consequences of this policy in Alabama. This type of demonstration effect is one of the main justifications for federalism.

C. Long-Arm Jurisdiction and Interstate Appropriation of Wealth

Under the theory just presented, a state court's punitive damages awards should be subject to federal review only when it is impracticable for the subject firm to charge the costs of the awards in the legal jurisdiction that awarded the damages. Indeed, the Supreme Court's punitive damages decisions can be explained using this theory, though the Court itself did not articulate the theory when it decided the cases. Before turning to that subject, however, we need to consider an important legal obstacle that interferes with the ability of firms to charge the costs of punitive damages awards in the jurisdictions responsible for those awards.

Under the famous case of *International Shoe Co. v Washington,*[59] the Supreme Court held that a corporation foreign to the state could be sued within the state if the corporation had certain

[59] 326 US 310 (1945).

"minimum contacts" with the state. International Shoe, which was sued in Washington, had no office in Washington and made no contracts either for sale or purchase of merchandise there. Further, it maintained no stock of merchandise in that state and made no deliveries there of goods in intrastate commerce (instead shipping all orders f.o.b. from point outside Washington). Nevertheless, International Shoe employed eleven to thirteen salesmen under the direct supervision and control of sales managers located in St. Louis. These salesmen resided in Washington; their principal activities were confined to that state; and they were compensated by commissions based upon the amount of their sales. The Court held that these contacts with the state of Washington brought International Shoe within the jurisdiction of the Washington courts.

In a more recent Supreme Court case, *Burger King Corp. v Rudzewicz,*[60] the Court held that Michigan franchisees could be sued by the franchisor in Florida. The plaintiff franchisor was a Florida corporation whose principal offices were in Miami. The Miami headquarters set policy and worked directly with the franchisees in attempting to resolve major problems. Day-to-day monitoring of franchisees, however, was conducted through district offices that in turn reported to the Miami headquarters. The defendant was a Michigan resident who, along with another Michigan resident, entered into a 20-year franchise contract with appellant to operate a restaurant in Michigan. Subsequently, when the restaurant's patronage declined, the franchisees fell behind in their monthly payments.

After extended negotiations among the franchisees, the Michigan district office, and the Miami headquarters proved unsuccessful in solving the problem, headquarters terminated the franchise and ordered the franchisees to vacate the premises. They refused and continued to operate the restaurant. Appellant then brought a diversity action in federal district court in Florida, alleging that the franchisees had breached their franchise obligations and requesting damages and injunctive relief. The franchisees claimed that, because they were Michigan residents and because appellant's claim did not *arise* from conduct within Florida, the district court lacked personal jurisdiction over them. But the court held that the franchisees were subject to personal jurisdiction pursuant to Florida's long-arm statute, which extended jurisdiction to any person, whether or not a citizen or resident of the State, who breaches a contract in the State by failing to perform acts that the contract requires to be performed there. Thereafter, the court

[60] 471 US 462 (1985).

entered judgment against the franchisees on the merits. The court of appeals reversed, holding that the assertion of personal jurisdiction under these circumstances would offend the fundamental fairness which is the touchstone of due process.

The Supreme Court held that the Florida courts did have jurisdiction and that Florida's long-arm statute did not violate the Due Process Clause of the Fourteenth Amendment. In a key passage, the Court said:

> This "purposeful availment" requirement ensures that a defendant will not be haled into a jurisdiction solely as a result of "random," "fortuitous," or "attenuated" contacts, or of the "unilateral activity of another party or a third person." Jurisdiction is proper, however, where the contacts proximately result from actions by the defendant himself that create a "substantial connection" with the forum State. Thus where the defendant "deliberately" has engaged in significant activities within a State, or has created "continuing obligations" between himself and residents of the forum, he manifestly has availed himself of the privilege of conducting business there, and because his activities are shielded by "the benefits and protections" of the forum's laws it is presumptively not unreasonable to require him to submit to the burdens of litigation in that forum as well.[61]

Although the Supreme Court decisions in *International Shoe* and *Burger King* allowed jurisdiction against out-of-state entities, the Court's decision in *World-Wide Volkswagen Corp. v Woodson*[62] showed that this type of jurisdiction is not unlimited. The World-Wide Volkswagen plaintiffs, the Robinsons, were a family that had been living in New York. While in that state they purchased a new Audi from a New York dealership, which did business only in that state. The dealership had in turn purchased the Audi from a regional distributor, the defendant World-Wide Volkswagen Corp., which sold to dealers only in New York, New Jersey, and Connecticut. One year after their purchase of the Audi, the plaintiffs decided to move to Arizona, and they traveled there in their Audi. While en route, in the state of Oklahoma, another driver struck their Audi in the rear; the Audi caught fire and burned Mrs. Robinson and her two children. They sued, among others, the New York dealership from which they had purchased the automobile and World-Wide Volkswagen, the tri-state Audi distributor from which their retailer had

[61] 471 US at 475-76 (footnotes and citations omitted).

[62] 444 US 286 (1980).

purchased.[63] The case before the United States Supreme Court arose when the out-of-state retailer and the distributor protested the Oklahoma trial court's exercise of jurisdiction over them. The Oklahoma Supreme Court held that the state's long-arm statute allowed these two defendants to be sued in Oklahoma, even though neither did any business there; they appealed this adverse determination to the United States Supreme Court on the ground that Oklahoma's claim of personal jurisdiction violated the Due Process Clause.

In *World-Wide Volkswagen,* unlike *International Shoe* and *Burger King,* the Court held that the forum state had no jurisdiction over the out-of-state corporations. The Court stressed that neither of the corporations solicited business in Oklahoma or from Oklahomans. Although the Court conceded that it was somewhat "foreseeable" that an automobile purchased in New York might be driven through Oklahoma, it found that this fact was insufficient by itself to confer jurisdiction on that state's courts over the automobile distributor. The court did not have before it the question of the Audi manufacturer's liability to suit in Oklahoma, presumably because Audi itself sold cars there, so that jurisdiction was clear. Moreover, the Court also emphasized that a contrary doctrine would make it impossible for a corporation to exit a state. Quite consistently with the theory described above, the Court at least suggested the possibility of exit as a control on abusive state regulation. It reasoned that state jurisdiction so broad as to prevent exit by firms with nominal ties to a state would violate the Due Process Clause.

Although the Court correctly reasoned that the law must leave firms with a realistic ability to exit a state, its language did not clearly create any realistic safe harbor:

> Applying these principles to the case at hand, we find in the record before us a total absence of those affiliating circumstances that are a necessary predicate to any exercise of

[63] In an action for defective products, most states allow an injured consumer to sue retailers and distributors, not just manufacturers. In the usual situation, the retailers and distributors can receive indemnification back from the manufacturer if they are held liable. For example, *Vandermark v Ford Motor Co.,* 391 P2d 168 (Cal 1964); *Mead v Warner Pruyn Division,* 394 NYS2d 483 (App Div 1977) (refrigerator retailer strictly liable for manufacturing defect that caused it to burn down the plaintiff's house); *Brumbaugh v CEJJ, Inc.,* 547 NYS2d 699 (App Div 1989) (retail "agent" of manufacturer strictly liable); *Gokey v Castine,* 558 NYS2d 308 (App Div 1990) (farm equipment retailer strictly liable if "regularly engaged in the business" of selling farm equipment); *Peterson v Bachrodt Chevrolet Co.,* 329 NE2d 785 (Ill 1975) (stating that retailer would be strictly liable for defect present at time product it retailed left manufacturer); *Tarwacki v Royal Crown Bottling Co. of Tampa,* 330 So2d 253 (Fla Dist Ct App 1976) (stating that in Florida "retailers may be held accountable" for product defects); *Hovenden v Tenbush,* 529 SW2d 302 (Tex Civ Ct App 1975) (retailer of used bricks strictly liable). But see *Ellis v Rich's, Inc.,* 212 SE2d 373 (Ga 1975) (holding retailer immune from strict liability); *Sam Shainberg Co. v Barlow,* 258 So2d 242 (Miss 1972) (denying strict liability of retailer).

> state-court jurisdiction. Petitioners carry on no activity whatsoever in Oklahoma. They close no sales and perform no services there. They avail themselves of none of the privileges and benefits of Oklahoma law. They solicit no business there either through salespersons *or through advertising reasonably calculated to reach the State.* Nor does the record show that they regularly sell cars at wholesale or retail to Oklahoma customers or residents or that they *indirectly, through others,* serve or seek to serve the Oklahoma market. In short, respondents seek to base jurisdiction on one, isolated occurrence and whatever inferences can be drawn therefrom: the fortuitous circumstance that a single Audi automobile, sold in New York to New York residents, happened to suffer an accident while passing through Oklahoma.[64]

Because of the ambiguity of the references to indirect efforts to serve the Oklahoma market, the Court left open the possibility that those dealing in nationally marketed products would be entirely unable to exit particular states.

The last relevant case in the sequence is *Asahi Metal Industry Co., Ltd. v Superior Court of California.*[65] This involved a dispute between Asahi, a Japanese manufacturer of tire valves, and Cheng Shin Rubber Industrial, a Taiwanese tire manufacturer, regarding valves made by Asahi and installed by Cheng Shin in tires made in Taiwan. Such a tire was ultimately involved in an accident in California. A divided Supreme Court ultimately found that California courts could not assert jurisdiction. However, for our purposes, what is interesting is that only four Justices (O'Connor, joined by Rehnquist, Powell, and Scalia) believed that "a defendant's awareness that the stream of commerce may or will sweep the product into the forum State does not convert the

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[64] 444 US at 295 (footnote omitted and emphasis added). The Court also said:

> When a corporation "purposefully avails itself of the privilege of conducting activities within the forum State," *Hanson v. Denckla,* 357 U.S., at 253, it has clear notice that it is subject to suit there, and can act to alleviate the risk of burdensome litigation by procuring insurance, passing the expected costs on to customers, or, if the risks are too great, severing its connection with the State. Hence if the sale of a product of a manufacturer or distributor such as Audi or Volkswagen is not simply an isolated occurrence, but arises from the efforts of the manufacturer or distributor to serve, directly or *indirectly,* the market for its product in other States, it is not unreasonable to subject it to suit in one of those States if its allegedly defective merchandise has there been the source of injury to its owner or to others. The forum State does not exceed its powers under the Due Process Clause if it asserts personal jurisdiction over a corporation that delivers its products into the stream of commerce *with the expectation* that they will be purchased by consumers in the forum State. Cf. *Gray v. American Radiator & Standard Sanitary Corp.,* 22 Ill. 2d 432, 176 N. E. 2d 761 (1961).

Id at 297-98 (emphasis added).

[65] 480 US 102 (1987).

mere act of placing the product into the stream into an act purposefully directed toward the forum State."[66] If this were the law, then exit from a state with defective laws would be feasible. But this proposition could not command a majority of the Court.

Using our theory, it is possible to extend, formalize and correct the Court's theory. The ostensible purpose of most state economic regulation is to increase efficiency. Nevertheless, it is also possible for a state to develop regulation for the purpose of appropriating wealth from out-of-state residents. An excessive airport tax would be one example. More mundanely, a state that promotes unduly generous tort recoveries could enrich that state's lawyers at the expense of the citizens of other states. Nevertheless, generous recoveries will also impoverish the state's own citizens through the various inefficient substitutions that it will induce. For a state's appropriation of out-of-staters to be effective, it must somehow be disproportionately directed against a large proportion of transactions that are not undertaken by the state's own citizens. Thus, the Court's doctrine that the defendant must have "minimum contacts" with the state makes good economic sense. The transaction must be one in which the state's own citizens could have an economic interest, because that interest guarantees, to some extent, that the regulation will aim at efficiency and not at mere appropriation. However, if merely putting an item into the stream of commerce creates potential liability, then the issue becomes more difficult, and appropriation again becomes possible. Under this reading, it is difficult for a manufacturer to know if it is possible to exit a state.

This analysis in turn suggests that the economically harmful effects of excessive punitive damages awards by unrestrained juries in particular states could, to the extent that they are not already policed by the mechanisms of federalism, largely be ameliorated by a clear and realistic "minimum contacts" doctrine. Justice O'Connor's opinion in *Asahi* suggests how such a doctrine could be formulated, but the Court has not accepted her approach. The *Gore* approach to punitive damages, in turn, can be understood as effort to arrive at roughly the same result through a different path.

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[66] Id at 112. The uncertainty created by the Supreme Court's minimum contacts doctrine was heightened by the decision in *Burnham v Superior Court,* 495 U.S. 604 (1990), which affirmed a state court's exercise of personal jurisdiction over a nonresident, who was personally served with process while temporarily in the state, in a suit unrelated to his activities in the state. As in *Asahi,* the Court was unable to produce a majority opinion, but the holding appears to be that there is an exception to the minimum-contacts requirement for some traditionally accepted rules allowing jurisdiction.

D. The Theory Applied: *Gore* and *Oberg*

In the situation that gave rise to the *Gore* case, BMW would find it difficult but not impossible to cease doing business in Alabama if it could thereby acquire immunity from Alabama tort juries. It could close all of its dealerships. It could not, however, prevent Alabamians and others from bringing their BMWs into the state. Once the BMWs were inside the state, the owners would demand parts. It would seem that any shipment by BMW of parts into Alabama would establish the minimum contacts that would confer jurisdiction on that state's courts. Even if BMW refused to sell parts in Alabama, independent parts dealers could buy parts and resell them in Alabama. This behavior would impose costs on Alabamians, but the costs would be a result of their decision to impose excessive punitive damages. Before BMW would undertake such a policy, however, it would want an indication from the Supreme Court that in fact this behavior would immunize it from any application of an Alabama long-arm statute. Under the *International Shoe* line of cases, BMW could not be sure to escape liability: because it is easily foreseeable that independent parts dealers (and perhaps even independent car dealers) would begin operating in the Alabama market, it is quite conceivable that BMW would be regarded as having sought "indirectly" to serve that market.[67] The current precedents are sufficiently vague that BMW or another manufacturer might try its best to forego the Alabama market, but still be subject to Alabama's long-arm jurisdiction.

This may help to explain why the Supreme Court refused to allow the punitive damages award in Gore. Similarly, in *Honda Motor Co. Ltd. v Oberg*,[68] the Supreme Court regulated a state punitive damages award. After finding the defendant Honda Motor Co. liable for injuries that the plaintiff Oberg received while driving a three-wheeled all-terrain vehicle manufactured and sold by Honda, an Oregon jury awarded Oberg $5,000,000 in punitive damages, which was over five times the amount of his compensatory damages award. In affirming, both the state court of appeals and the state supreme court rejected Honda's argument that the punitive damages award violated due process because it was excessive and because Oregon courts have no power to correct excessive verdicts "unless the court can affirmatively say there is no evidence to support the verdict." The United States Supreme Court held that Oregon's denial of review of the

[67] See *World-Wide Volkswagen*, 444 US at 295, 297-98 (quoted above in Part IV.C).

[68] 114 S Ct 2331 (1994).

size of punitive damages awards violated the Fourteenth Amendment's Due Process Clause. However, the Oregon Supreme Court then heard the case and affirmed the lower court's award: compensatory damages of $919,390.39 and punitive damages of $5,000,000. After deciding Gore, the Supreme Court denied certiorari on the issue of the magnitude of damages.[69]

The initial Supreme Court decision in *Oberg* was less radical than in *Gore*, because the United States Supreme Court held only that the Oregon Supreme Court itself had to assess the reasonableness of punitive damages. Still, the decision did constitute federal regulation of a state's punitive damages regime, and it therefore presented much the same federalism issue as the Gore case. Indeed, *Oberg* was highly analogous. Honda is of course also a seller of automobiles and would find it just as difficult to exit Oregon, given existing long-arm jurisdiction doctrines, as BMW would find it to exit Alabama. Again, however, if the minimum-contacts doctrine were drawn more clearly, and if it paid to do so, Honda might cease selling in Oregon. That option, however, was not available.

E. The Theory Applied: Refusals to Interfere

In the cases in which the Supreme Court has refused to reverse punitive damages awards, the defendants would have found it far easier to exit the awarding jurisdictions. In *Browning-Ferris Industries v Kelco Disposal, Inc.,*[70] for example, Kelco filed suit against Browning-Ferris in federal district court, charging Browning-Ferris with antitrust violations and with interfering with Kelco's contractual relations in violation of Vermont tort law. A jury found Browning-Ferris liable on both counts, and awarded Kelco, in addition to $51,146 in compensatory damages, $6 million in punitive damages on the state-law claim. Denying Browning-Ferris' post-trial motions, the district court upheld the jury's punitive damages award. The court of appeals affirmed as to both liability and damages, holding that even if the Eighth Amendment were applicable, the punitive damages awarded were not so disproportionate as to be constitutionally excessive.

The Supreme Court based its decision to allow the award on the defendants' failure to argue that the punitive damages award violated the Due Process Clause, but the result was consistent with our theory. Although the defendant operated a nationwide disposal service, it could have

[69] 116 S Ct 1847 (1996). For an analysis of ATV risks, showing that they are no riskier than similar products (and thus presumably not worthy of punitive damages), see Gregory B. Rodgers and Paul H. Rubin, *Cost-Benefit Analysis of All-Terrain Vehicles at the CPSC,* 9 Risk Analysis 63, 68 n 6 (1989).

[70] 492 US 257 (1989).

easily exited Vermont, if inefficient punitive damages awards proved to be a problem in that state. Waste management services provided in New Hampshire cannot migrate to Vermont. In this economic sense, waste management services are different from BMWs and Hondas. Although intemperate Vermont decisions might deny New Hampshire residents the benefits of some economies of scale, it seems unlikely that this would be a significant cost for them. Hence, because exit from Vermont would be so practical, no justification for federal regulation exists. Excessive punitive damages awards by Vermont courts would be borne almost exclusively by Vermonters.

Similarly, in *Pacific Mutual Life Insurance Co. v Haslip,*[71] the plaintiff, who lived in Alabama, sued her employer's insurance company for fraud committed by one of its agents. The fraud had the effect of denying her health insurance coverage. The Alabama jury made a large punitive damages award, which the United States Supreme Court held did not violate the Due Process Clause. Again, it would be practical for the insurance company to exit Alabama. The plaintiff and her employer were both located there. No external economic consideration compelled the defendant to offer insurance coverage in Alabama.[72] In this way, it could avoid exposing itself to punitive damages awards by intemperate Alabama juries.

Finally, in *TXO Production Corp. v Alliance Resources Corp.,*[73] a West Virginia jury awarded damages against a Texas lessee of oil and gas rights beneath West Virginia land. The defendant had behaved fraudulently in seeking to reduce its royalties. Although the United States Supreme Court was unable to produce a majority opinion, it affirmed the state court judgment of for $19,000 in compensatory damages and $10 million in punitive damages. If anything, this award of punitive damages was more outrageous than the judgment that would later be reversed in the *Gore* case: it was, for example, a much larger multiple of the actual damages. Consistent with our theory, however, this was a case in which the defendant could have avoided the risk of such an award by declining to do business in West Virginia.

Writing in dissent, Justice O'Connor (joined by Justice White and, in part, by Justice Souter)

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[71] 499 US 1 (1991).

[72] If an insured has multiple installations, the defendant could presumably choose to insure only the Georgia installations and not the Alabama ones.

[73] 509 US 443 (1993).

argued that the plaintiff's attorney had impermissibly prejudiced the jury by appealing to the natural temptation to transfer wealth from deep-pocket out-of-state corporate defendants to in-state plaintiffs. She was probably right, and it is easy to agree that the trial court behaved irresponsibly by licensing the jury to award punitive damages in any amount they believed appropriate and by encouraging the jury to base an award on TXO's wealth alone. But this forceful argument by Justice O'Connor neglects the free choice made by the defendant to do business in West Virginia. It is not necessary for an oil and gas production company to bear this West Virginia risk of intemperate jury awards. The firm could easily refuse to enter West Virginia. Hence, all costs of inefficiency would be charged to West Virginians, who are presumed to be the best judges of the type of economy that they wish to possess. No economic justification existed for federal regulation of this award, and the Supreme Court in fact did not regulate it.

F. Federalism in *Gore:* The Majority

Federalism was an important issue in the *Gore* dissents, but it also got considerable attention from the majority. The original jury verdict of $4,000,000 in punitive damages was aimed at removing from BMW the gains from its repainting without notification of 1,000 cars nationwide, at a cost to consumers of $4,000 per car. The Alabama Supreme Court reduced this to $2,000,000 on the ground that BMW should not be liable in Alabama for harms inflicted on consumers in other states. The majority asserted that "a State may not impose economic sanctions on violators of its laws with the intent of changing the tortfeasors' lawful conduct in other States."[74] But this analysis is one-sided. A decision such as the Alabama decision in *Gore* has costs and benefits. The benefits of the decision are the presumably desired changes in behavior: BMW will no longer sell repainted cars in Alabama without disclosure. The costs are the increase in the price of goods brought about by the fear of future decisions like this. The Court restricted its analysis to benefits: it discussed the presumed benefits to Alabamians of their policy, and argued that Alabama could not impose these same benefits on citizens of other states if these citizens did not want them. But it did not discuss costs. The Court apparently believes that damages are simply paid by stockholders of the firms that actually write the checks.

[74] 116 S Ct at 1597 (footnote omitted).

In the past, this may have been true. If punitive damages are rare,[75] then the prices of goods and services provided by firms potentially subject to paying punitive damages will not adjust, and assessment of such damages will simply be a windfall loss to the firms that pay them. Similarly, if firms can behave in ways calculated to insulate themselves from such damages, then again, firms that do not engage in undesirable behavior will not view the potential for such damages as a cost. In today's world, however, neither of these conditions holds. Punitive damages are not rare, and are becoming more common. Moreover, firms are assessed such damages for normal business behavior, so that a firm cannot guarantee that it will not be assessed punitives by merely behaving ethically and honestly. In this situation, prices will rise to adjust to the higher level of costs associated with doing business. Ex ante, punitive damages will be paid for by consumers of relevant goods or services. Thus, the Supreme Court erred in ignoring the cost side of the issue in its analysis.

If the Court had considered this issue in a more principled way, it would have realized that citizens in other states are forced to bear the costs of Alabama's desires to protect its consumers (or to reward its tort lawyers.) While as a society we are willing to tolerate some imposition of costs in order to maintain principles of federalism, our willingness may be limited. Cases such as BMW impose costs sufficiently great that it may be time for the Supreme Court to say "enough." However, it is not clear that the Court itself understands the nature of the costs imposed, and it is not clear that it will correctly preserve as much federalism as possible while still limiting externalities.

On the other side, Justice Scalia's dissenting opinion did not give adequate attention to the inadequacy of relying on federalism to allocate the costs imposed by excessive and excessively frequent punitive damages awards. Had the dissent suggested that the Court should consider narrowing and clarifying the Court's long-arm decisions, its analysis would have been far more plausible. Therefore, a decision like *Gore*, while not the first best that could be achieved, may be the second best, and it is definitely an improvement.

V. CONCLUSION

In the past, punitive damages appear to have been confined to cases of egregious infliction of harm, including intentional torts, intentional negligence, and cases where tortfeasors made

[75] See Landes & Posner, *Economic Structure of Tort Law* at 302-307 (cited in note 9).

efforts at concealment. They formed only a small part of the overall tort system. If confined to such a role, punitive damages could serve a useful function in the tort system by providing needed deterrence when normal damages would not suffice.

More recently, however, punitive damages have escaped this efficient bound. Juries have begun awarding such damages in bizarre circumstances, and courts have been willing to uphold such awards. A manufacturer is found liable for some injury associated with its product under what may be a negligence standard, and the fact that the manufacturer knew of the possibility of such an injury is used in effect to convert negligence into an intentional injury. Similarly, if the manufacturer did not publicize the risk of this harm, it was engaged in concealment. Either of these circumstances will then be used to justify an award of punitive damages. In these situations, punitive damages have two effects, both harmful to consumers. One is to force consumers to pay higher product prices in order to cover the costs of a punitive damages lottery whose expected value is much less than its cost. A second is to increase the burden from mandatory over-insurance for pain and suffering. Again, such insurance is worth far less than its costs. These effects reduce consumer welfare. Therefore, there are efficiency gains from reducing the discretion of juries and state courts in awarding such damages. In that sense, *Gore* was correctly decided.

This same reasoning applies with equal or greater force to products associated with health risk, such as pharmaceuticals. Some of the language in *Gore* indicates that the Court may not understand this. It will be interesting to observe what happens when a punitive damages case involving a risk-reducing product such as a pharmaceutical or a medical device comes before the Supreme Court.

The most interesting issue raised by *Gore* is the federalism issue: is it appropriate for federal courts to interfere with state court decisions on damages? Our analysis concludes that it is appropriate if citizens in one state can use the judicial process to extort wealth from citizens in other states. Under current constitutional doctrines regulating the use of long-arm statutes, this appears to be true of most goods that are widely distributed, such as BMW automobiles. It is not true of goods or services sold within the boundaries of one state, such as trash removal services, medical insurance, and land, all of which were involved in recent cases in which the Court upheld large punitive damages awards. Under appropriate constitutional limits on long-arm statutes, it might not even apply to widely-distributed products, but the Supreme Court has not

decided to enforce such limits. Thus, so far at least, the Supreme Court's actual decisions seem to have gotten the federalism issue right, given that the Court is not willing to deal directly with the problems created by its long-arm jurisprudence. Since there is no evidence in either the *Gore* majority opinion, or in the dissents, that the Court has a proper understanding of the federalism issue, it will be interesting to see if the Court continues to reach economically correct decisions.