Due Process and Punitive Damages: An Economic Approach

Keith Hylton

Follow this and additional works at: https://scholarship.law.bu.edu/faculty_scholarship

Part of the Torts Commons
DUE PROCESS AND PUNITIVE DAMAGES: AN ECONOMIC APPROACH

KEITH N. HYLTON

This paper can be downloaded without charge at:

The Boston University School of Law Working Paper Series Index:

The Social Science Research Network Electronic Paper Collection
http://ssrn.com/abstract_ID=1020262
Due Process and Punitive Damages:
An Economic Approach

Keith N. Hylton*

October 2007

Abstract: This paper sets out a public choice (rent-seeking) theory of the Due Process Clause, which implies that the function of the clause is to prevent takings through the legislative or common law process. This view of the clause’s function supports a preference for expanding rather than contracting the set of entitlements protected by the clause. The Supreme Court’s application of due process reasoning in the punitive damages case law is in some respects consistent and in other respects inconsistent with this theory. For the most part, the Court has failed to develop a set of doctrines that would enable lower courts to distinguish takings from punishment consistent with reasonable regulation. This paper suggests general guidelines for developing such doctrines.

* Professor of Law, Boston University, knhylton@bu.edu. I thank Noemi Kawamoto for research assistance. For helpful comments I thank Jack Beermann, Jim Fleming, Gary Lawson, Bill Treanor, David Walker, Ben Zipursky, and participants in faculty workshops at Fordham University Law School and at Boston University.
The Supreme Court’s most recent foray into punitive damages law, *Philip Morris v. Williams*, held that the Due Process Clause prohibits a state court from deliberately imposing a penalty in the form of punitive damages on a defendant for harms that the defendant has done to victims other than the plaintiff. However, the court may still enhance an award to take into account the reprehensibility of the defendant’s conduct. Thus, if the defendant harmed two plaintiffs in the amount of $100 each, it would violate due process to give one plaintiff $100 in compensatory damages and an additional $100 for the express purpose of penalizing the defendant for the harm done to the other victim. But it would not necessarily violate due process if the state court awarded a punitive judgment as a reflection of the reprehensibility of the defendant’s conduct.

As this brief description suggests, *Philip Morris* falls short of providing guidance to lower courts on what to do with punitive damage awards. Some courts may choose to focus solely on the reprehensibility approach and continue to award the same punitive judgments they had been awarding all along, though now armed with the understanding that justifications for the judgments should be couched in terms of reprehensibility. Other courts may avoid handing down any punitive award that looks like it could be a penalty for victims other than the plaintiff. The likely result is that the Supreme Court will have to revisit the issues it attempted to answer in *Philip Morris*.

The part of *Philip Morris* that is most likely to help guide lower courts is the Court’s decision to ground its reasoning in procedural due process language. This is a retreat from the path of the recent punitive damages decisions based on substantive due process reasoning. Indeed, it may signal a decision on the part of the Court to back away from substantive due process analysis of punitive damages. Such a move would permit lower courts to better predict the outcomes of future Court decisions, and by doing so, allow the law on punitive damages to settle and get out of the Court’s orbit.

---

2 *Id.* at 1065.
3 *Id.*
4 The court noted that it did not need to consider “whether the award...at issue [was] ‘grossly excessive’” and therefore considered only “the Constitution’s procedural limitations,” *Id.* at 1063. The court explained that it would violate the Constitution’s Due Process Clause to instruct the jury that it may award punitive damages for the injuries of a non-party victim because the defendant would have no opportunity to defend itself with regard to the non-party victim. *Id.* The court emphasized the need for juries to ask the “right question” and for “States to avoid procedure that unnecessarily deprives juries of proper legal guidance” with regard to awarding punitive damages. *Id.* at 1064. Presumably the proper question for juries to ask is the degree of reprehensibility of the defendant’s conduct, and not the harm the defendant may have caused other victims.
5 See, e.g., *State Farm Mut. Auto Ins. Co. v. Campbell*, 538 U.S. 408 (2003); *BMW of North America, Inc. v. Gore*, 517 U.S. 559 (1996). I realize that there is a small controversy over whether the Supreme Court’s new case law should be referred to as having a “substantive due process” component. The Court has continued all along to use language that suggests that its reasoning is based in procedural concerns, such as providing notice to potential defendants. However, it has become a common practice now to refer to these cases as introducing substantive due process analysis. This is largely because of the Court’s recent references to an excessiveness limit, such as the “single-digit ratio” suggested in *State Farm*. *Id.* at 425.
I will argue here that there is nothing troubling as a matter of theory about the extension of substantive due process reasoning to the punitive damages cases. Nor should we be troubled by substantive due process as a general approach toward the constitutional review of statutes or state court decisions. The problem in the punitive damages cases is in the *application* of substantive due process reasoning, which is deeply flawed. To support my argument, I will set out a model of due process analysis and apply it to the punitive damages issue.

In the model set out below, the function of the Due Process Clause is to prevent takings through the legislative or common law process. This view of the clause’s function supports an expansive approach – i.e., a preference for expanding rather than contracting the set of entitlements protected by the clause. The Supreme Court’s application of due process reasoning in the punitive damages case law is in some respects consistent and in other respects inconsistent with this theory. For the most part, the Court has failed to develop a set of doctrines that would enable lower courts to distinguish takings from punishment consistent with reasonable regulation. Indeed, the Court’s current analysis appears to restrict a state from levying a penalty that is optimal on deterrence grounds, which encourages takings resulting from the intentional disregard by potential tortfeasors of the interests of potential tort victims. One goal of this paper is to provide economic guidelines for distinguishing takings from reasonable regulation through common law rules.

One general guideline suggested below is that if the punitive award both effects a substantial wealth transfer and is inconsistent with reasonable regulation, then it is potentially a taking. This determination requires some analysis of the incentive effects created by the award. The mere fact that the punitive award is large, or large in relation to a compensatory award, is of no importance to the takings analysis in the absence of some consideration of the deterrence implications of the award.

I. Theory of Due Process

In order to have some sense of the appropriateness of substantive due process reasoning in the context of punitive damages, one needs first a somewhat rigorous and general theory of the objective or function of substantive due process analysis. Moreover, such a theory, to be useful in examining punitive awards, should include some economic analysis component. After all, punitive damages are designed to deter. Economic analysis has been used, since Beccaria, to understand the relationship between damages and incentives. Since little effort has been made in the constitutional theory area to use

---

6 I will not argue that the application of due process reasoning is flawed because of inconsistencies in the case law. For such arguments, see Erwin Chemerinsky, *The Constitution and Punishment*, 56 STAN. L. REV. 1049 (2004); Pamela S. Karlan, “Pricking the Lines”: The Due Process Clause, Punitive Damages, and Criminal Punishment, 88 MINN. L. REV. 880 (2004).


economic reasoning to understand the function of constitutional provisions,\textsuperscript{9} I will do so largely working from the ground up here.

The Due Process Clause of the Fourteenth Amendment says that no State shall "deprive any person of life, liberty, or property, without due process of law."\textsuperscript{10} The consensus position among constitutional theorists today is that this clause should be understood primarily to set limits on procedure.\textsuperscript{11} The textual interpretation argument runs roughly as follows: no one is protected absolutely from being deprived of life, liberty or property by the Constitution. After all, you can lose your property as the result of a court judgment or a tax. What the Constitution prohibits a state from doing is depriving you of your property or liberty or life without following established and reasonable procedures.

In addition to this simple textual analysis, the consensus position is based on a view that the Court’s most notorious foray into substantive due process, the \textit{Lochner} case law,\textsuperscript{12} was a failure in most important respects. The consensus view is that the \textit{Lochner} cases, which invalidated on due process grounds statutes limiting employer freedom with respect to the setting of wages and hours, served the primary purpose of protecting wealthy and powerful industries such as the railroads from regulatory efforts by state legislatures.\textsuperscript{13} Some important parts of the New Deal labor legislation, and of state level
regulation passed at roughly the same time, could never have been sustained by courts if the *Lochner* era case law had remained in effect. In the consensus view, it would have been harmful to social welfare for the *Lochner* case law to remain on the books. Thus, in terms of the real substance that matters, which is whether legislatures can enact laws to improve the welfare of citizens, the substantive due process case law was unhelpful according to the consensus because it imposed constraints on the power of voters through their legislatures to take steps to improve welfare.

Both the textual and welfare-based arguments against Lochnerism are unpersuasive. Consider the textual argument first.

The Due Process Clause, though relatively short, consists of two commonly examined parts. One is an abstract definition of the set of protected *entitlements*: life, liberty, or property. The second is an abstract definition of the *transfer process* by which those entitlements can be taken by the state: only through due process of law. The clause consists of both a substantive and a procedural component. The substantive component is the general definition of the space of constitutionally protected entitlements. The procedural component is the description of the constitutionally acceptable transfer process.

Courts that have to interpret the Due Process Clause are forced by the wording of the provision to determine whether a particular entitlement is within the set of protected entitlements and whether the challenged transfer process is permissible. The first issue is unavoidably a question of substance. The second is just as clearly a question of procedure. The claim that the provision is concerned only with procedure is difficult to accept as a textual matter.

To assert, for example, that consensual homosexual sodomy is not within the set of constitutionally protected endowments, as the Supreme Court did in *Bowers v. Hardwick*, is to set a boundary line on the question of substance. In other words, *Bowers* is a substantive due process decision because it set a restriction on the space of protected endowments. *Bowers* says very little about procedure, other than that the state, within limits largely determined by criminal law doctrines, does not need to worry particularly about the procedures it uses to regulate homosexual sodomy. Just as

---

14 U.S. CONST. amend. XIV, § 1.
15 Id.
16 For perhaps the most famous statement of the argument that clause is concerned only with procedure, see JOHN HART ELY, DEMOCRACY AND DISTRUST 18 (1980) (stating that “[s]ubstantive due process is a contradiction in terms – sort of like ‘green pastel redness.’”).
17 478 U.S. 186 (1986).
18 *Bowers* “raises no question about the right or propriety of state legislative decisions to repeal their laws that criminalize homosexual sodomy, or of state-court decisions invalidating those laws on state constitutional grounds. The issue presented is whether the Federal Constitution confers a fundamental right upon homosexuals to engage in sodomy and hence invalidates the laws of the many States that still make such conduct illegal and have done so for a very long time.” *Bowers*, 478 U.S. at 190.
clearly, *Lawrence v. Texas* is a substantive due process decision because it declares that homosexual sodomy is within the set of constitutionally protected endowments.\(^{19}\)

It would be needlessly restrictive to describe *Lawrence* as a substantive due process decision and *Bowers* as something else. Any decision defining the scope of constitutionally protected entitlements is a substantive due process decision, whether it expands the set or contracts it. However, it appears to have been the norm among constitutional law specialists to describe only those decisions that expand the set of constitutionally protected entitlements as applications of substantive due process theory. This approach needlessly restricts the definition of substantive due process because it treats decisions that expand the set of protected entitlements differently from decisions that either maintain or contract the set of protected entitlements.

This argument may appear clearer through a second example. Consider a famous criminal law case, such as *In Re Winship*.\(^{20}\) The Court held that proof beyond reasonable doubt is required in criminal trials under the Due Process Clause.\(^{21}\) Here, there was an obvious determination that freedom from deprivation of life or liberty as the result of a criminal conviction is within the set of constitutionally protected entitlements. In addition, that freedom could be extinguished only if the prosecutor proved guilt to a high level of probabilistic satisfaction.\(^{22}\)

It also follows in this argument that it would be consistent with the due process theory to hold that there are some things within the set of protected entitlements that cannot be taken by the state irrespective of the procedure. For example, consider the taking (e.g., imprisonment) of innocent children, either to satisfy the demands of a legislative majority or as punishment for some crime. A rational system of constitutional constraints might hold that such a taking is unconstitutional per se, regardless of the set of procedures used to govern the taking. The prohibition of “corruption of blood” as a punishment in the Constitution can be understood as an illustration of the existence of this boundary point.\(^{23}\)

Put simply, every decision that interprets the Due Process Clause includes a substantive and procedural component. For every such decision must determine whether the asserted right is within the set of protected endowments and the challenged procedure by which it was taken is constitutionally permissible.


\(^{21}\) Id. at 364.

\(^{22}\) Id.

\(^{23}\) “The Congress shall have Power to declare the Punishment of Treason, but no Attainder of Treason shall work Corruption of Blood, or Forfeiture except during the Life of the Person attainted.” U.S. CONST. art. III, § 2, cl. 2. “Corruption of blood” was part of a punishment for the crime of treason and meant that the family of the person accused of committing treason could not inherit the accused’s property. *See*, U.S. v. Brown, 85 U.S. 437, 441 (1965) (internal citation omitted).
Now consider the consensus argument based on welfare – the notion that substantive due process theory was used to protect business interests from state regulation. First, that notion has been disputed by others. The courts attempted to develop a set of rules that distinguished wealth transfers from desirable regulation. The labor statutes struck down in the *Lochner* case law often benefited one set of businesses at the expense of another (e.g. unionized businesses at the expense of non-unionized), so it misleads to describe the statutes as pitting business interests against labor interests. And even if the welfare-based argument against early substantive due process doctrine had not been disputed, it remains an argument based on assertion rather than empirical proof.

Second, the substantive due process protection, rather than being a special gift to businesses, can be explained as based on an expansive notion of property rights, and one that primarily benefited workers who were unprotected by unions and relatively unskilled. The *Lochner* notion of property rights holds that a worker’s entitlement to seek a job paying less than a statutory minimum wage or requiring more than a certain number of hours cannot be taken away by the state without some particularized set of procedures. However, this expansive notion of property rights should not be viewed as an attempt to protect a certain economic order or distribution of wealth, but as the necessary backdrop for an active effort to distinguish desirable from regulation from wealth transfers.

I realize that this field of study is so shot through with politics that it is difficult to make an argument on the basis of economics without being accused of promoting the interests of some faction. Still, the argument has to be made. The *Lochner* era statutes restricting work hours or fixing minimum pay rates were enacted as the result of pressure by relatively skilled and unionized workers. The statutes had the effect of stripping away part of the endowment set of the less-skilled and nonunion workers. Minimum wages, for example, reduce the demand for less-skilled employees relative to skilled employees.

---


26 A similar charge, governing roughly the same era, is that state courts adopted the negligence rule in order subsidize emerging industries. However, in a review of almost all of the state tort decisions in California and in New Hampshire during the 19th century, Gary Schwartz found no evidence of a bias to protect businesses. See Gary T. Schwartz, *Tort Law and the Economy in Nineteenth-Century America: A Reinterpretation*, 90 YALE L. J. 1717 (1981).

27 The specific language in the *Lochner* opinion is that “[u]nder [the Fourteenth Amendment] no state can deprive any person of life, liberty, or property without due process of law. The right to purchase or to sell labor is part of the liberty protected by this amendment, unless there are circumstances which exclude the right.” *Lochner*, 198 U.S. at 53.

At the same time, by making less-skilled workers less competitive in comparison to union labor, the statutes help secure union employment. In short, minimum wage statutes can be understood to operate as indirect takings. They reduce the value of the potential labor entitlement of less-skilled workers and enhance the wages of the skilled, typically unionized, workers.

Hence, it is probably incorrect to say that the *Lochner* era was bad for overall social welfare. Since the less-skilled tend to outnumber the highly skilled, a set of rules that increases the welfare of the less-skilled relative to the highly skilled probably improves the welfare of society overall. This is particularly likely when the rules encourage competition in a market, permitting the highly skilled to differentiate themselves on the basis of quality rather than price. And to the extent that such rules encourage skill investment, they enhance the welfare of both high and low skilled workers.

I have argued so far that substantive due process analysis is an unavoidable component of review under the Due Process Clause, and that in the expansive mode exemplified by *Lochner* it has for the most part been beneficial to social welfare rather than harmful. It is most controversial when it is used to expand the set of constitutionally protected entitlements. However, by expanding the set of protected entitlements, it has discouraged legislative factions from attempting takings through the legislative process.

This analysis suggests a theory of the Due Process Clause. It is that the clause serves the function of preventing or at least regulating various types of direct and indirect taking.29 The clause prevents legislative factions from enacting laws that deprive one group of some entitlement in order to enhance the wealth of the taking group.30 It follows under this model that the clause is designed to warn courts to keep their eyes open for efforts by group A to expropriate property directly from group B (direct takings), or indirectly through limiting the rights of or legal protections to group B in a way that works to enhance the wealth of group A (indirect takings). Hence, under the *Lochner* era, courts used the Due Process Clause to regulate indirect takings by preventing highly skilled and unionized workers from stripping the legal entitlements of the less skilled to compete by offering their services at lower wages.

The way to understand the function of the Due Process Clause, then, is to imagine a regime consisting of predatory, or merely self-interested, legislative factions. They are sitting by the sidelines, waiting to funnel money into the legislative process to take the things that they want. If they can pay their legislators $10 and expropriate from some targeted faction a benefit worth $100, they will do so. The purpose of the Due Process Clause is to make it difficult for these factions to enter the legislative game and get what they want. It is not a serious criticism of this theory of the clause’s function to say that it

29 A similar argument about the overall structure of the Constitution is provided in Macey, supra note 9. Macey focuses on structure rather than constitutional doctrine. Stout’s analysis, supra note 9, also differs from this paper’s because it supports a narrower scope of fundamental rights than suggested by this paper’s analysis.

cannot carry out this function perfectly. There will inevitably be cases in which a legislative faction hides its real motivations so well that courts will be unable to cancel or reverse its predatory grab. However, there will also be many cases in which courts will be able to identify the naked grab for what it is. And in these cases, the Due Process Clause will serve its purpose. The existence of this risk raises a barrier to predatory legislative factions.

This suggests that there are both positive and negative senses in which the Due Process Clause should function. The positive and negative senses correspond to the notions of direct and indirect takings. In the positive sense, the clause constrains predatory factions by prohibiting the enactment of laws that directly effect a taking. It should also operate in the negative sense by preventing the enactment of laws that strip parties of ordinary protections provided by the law. Such laws might be enacted at the behest of predatory factions so that they can go directly after their targets and rip them off without having to worry about the punishments that would ordinarily follow were the laws to operate without obstruction.31

The public choice (or rent-seeking) theory of the Due Process Clause holds that the function of the clause is to authorize courts to distinguish socially desirable regulation from predatory wealth transfers.32 This theory may seem close in some respects to Ely’s democracy-facilitating theory.33 Both theories reflect some degree of mistrust of the democratic process, though Ely’s involves a limited mistrust while the public choice theory’s mistrust is pervasive. However, Ely’s theory limits the scope of the clause’s protective function to groups that are unlikely to form effective legislative factions. From the perspective of rent-seeking theory, Ely’s limited view of the clause would be too narrow, because it would fail to work as a general deterrent to predatory governmental action.

The rent-seeking approach may also appear at first to be equivalent to libertarianism,34 which supports the most expansive view of fundamental rights. But the approach suggested here tries to steer away from rights talk. It focuses instead on the types of expropriation that should be regulated. Rights and liberties in general are already constrained by the common law of torts, and the libertarian view would require a skeptical view toward such constraints. That is not implied by the rent-seeking theory, which accepts welfare-enhancing regulations. The rent-seeking approach attempts to distinguish regulations that enhance social welfare from regulations that attempt to transfer wealth. While that implies an expansive approach toward substantive due process doctrine, it does not imply the maximization of liberty for its own sake.

---

31 For an example that might fit in the positive or negative category depending on the background, see Parsons v. Russell, 11 Mich. 113 (1863). The court invalidated a law permitting creditors to seize and sell property without having to prove their claims before a court.
32 I have suggested that the Lochner case law supports this theory, though I have not taken the time to present a detailed examination of that case law. That examination has already been provided by the revisionist literature on Lochner. See Gillman, supra note 24; Epstein, supra note 24.
33 Ely, supra note 16.
The expansive approach toward substantive due process reflected in *Lochner, Roe,*[^35] and *Lawrence* is potentially socially desirable and probably enhances society’s welfare. A simple case can be made that the expansive view of substantive due process, at the level of defining constitutionally protected entitlements, increases social welfare. That case runs as follows. Takings carried out through the legislative process, even the indirect sort policed by the *Lochner* case law, are generally indistinguishable from theft. Theft is bad because it destroys incentives to invest in productive assets, including human capital, and at the same time encourages the devotion of effort to the absolutely unproductive effort of taking. By prohibiting takings, the substantive due process case law supports productive investment and provides incentives for welfare-enhancing contracts between the predatory and target groups.

Consider the example of *Lochner* to illustrate this argument. When high-skilled labor groups obstruct access to the labor market by low-skilled groups, they shield themselves from competition and therefore lose some of their incentives to maintain the skill differential that makes them valuable in the first place. Second, many low-skilled workers are willing to accept relatively low wages because they serve as entry points in the labor market. These workers can start at low wages, develop skills in low-wage, training-based work, and then move on to high wage work later. By preventing high-skilled workers from blocking access to labor markets among the low-skilled, *Lochner* supported skill investments by both high and low-skilled workers. In addition, the *Lochner* barrier forced high-skilled workers to seek a contractual solution to any desires they had for exclusive control of a market. With the *Lochner* barrier in place, high-skilled workers could get exclusive access to a market only by buying out the low-skilled or the employers who want to hire them. To the extent that blocking access to the low-skilled may have been efficient, the contractual solution would permit efficient cases of access-blocking to occur.[^36]

The issues in *Roe* and *Lawrence* are clearly distinguishable on a number of grounds from those in the *Lochner* case law. One way of addressing these distinctions would be to say that the foregoing argument applies to economic interests only, an approach that is directly opposed to the law, which applies expansive substantive due process analysis primarily to sexual privacy matters.[^37] But that would be a cheap and unsatisfying response. The takings analysis that justifies *Lochner* still retains some applicability to the sexual privacy sphere. For example, although the homosexual sodomy right addressed in *Lawrence* does not effect wealth-creating investments, at least as most would understand the term, it does involve factions that have an interest in enhancing their status by enforcing conformity with their life-style views. In addition, the criminalization of

[^36]: Alternatively, unionization across a specific labor market could block access to low-wage workers. If unionization leads to higher quality work, the result could be one in which no low-wage firm can enter and compete successfully in the market because of quality differential. This could be a case of efficient access-blocking by high-skilled workers.
[^37]: For an economic approach the tries to justify existing law, by emphasizing privacy interests as fundamental, see Stout, *supra* note 9. Obviously, my approach differs from that of Stout in this respect. Stout refers to her approach as based on social choice theory rather than public choice theory. The approach taken there is based on public choice theory.
consensual homosexual sodomy encourages investments into the absolutely unproductive activity of blackmail.

Rather than raise questions about the appropriateness of expansive substantive due process analysis in the limited context of sexual privacy, the approach outlined here suggests that it would be preferable to see it broadened to include the economic rights protected in the *Lochner* case law. The existing equilibrium permits legislative predation to occur with respect to economic interests, while blocking some of that predation with respect to privacy. Social welfare probably would be enhanced if substantive due process analysis were allowed to serve as a general barrier to legislative predation.

II. Substantive Due Process and Damages

As commentators have noted, the punitive damages case law represents an odd direction for substantive due process law. The other areas of application have involved questions concerning the scope of the set of protected endowments.

The theory of the function of the Due Process Clause provided here is that it works to keep predatory factions from expropriating their targets. This theory, it should be clear, leads to both substantive and procedural restrictions on legislative enactments. We can apply this to damages.

A. Due Process and the Deprivation Quantum

In order to apply the theory developed in the previous part to damages, it will be worthwhile to modify it slightly. The theory set out above points to two key components of the Due Process Clause, the set of protected entitlements and the transfer process. In the context of damages, there are three components to take into consideration. One is the set of protected entitlements. Another is the transfer rule or process with respect to those entitlements. The third is the nature of the deprivation or the deprivation quantum. In the damages context, the nature of the deprivation is the damage amount assessed against the defendant.


39 The approach here takes a theoretical account of due process and applies it to damages. Others have started with an argument that due process requires a right to a remedy, and have argued from that premise that courts should not defer to state legislative efforts to restrict tort remedies. See John C. P. Goldberg, *The Constitutional Status of Tort Law: Due Process and the Right to a Law for the Redress of Wrongs*, 115 YALE L. J. 525 (2005); Tracy A. Thomas, *Restriction of Tort Remedies and the Constraints of Due Process: The Right to an Adequate Remedy*, 39 AKRON L. REV. 975 (2006). The view taken in this paper, in contrast to the articles just cited, is that the Due Process Clause implies constraints on government action. This general constraint implies rights, of course, but only as a complement to constrained government.
To draw the connection with constitutional text, the Due Process Clause (of the Fifth Amendment) says that “no person shall be ... deprived of life, liberty, or property, without due process of law”.\(^{40}\) It follows from the words of the provision that one can divide the provision into three components: deprivation quantum, protected entitlements, and transfer process. The preceding part of this paper limited its analysis to the latter two components. In this part, I will include the first component.

1. Takings and Damages: A Model

A taking can occur in the naked fashion of stripping property or a liberty interest from a certain group. A taking can also occur by adopting procedures that permit a property or liberty interest to be stripped from some group. Yet another way to arrange a taking is not to modify the set of protected entitlements, or the rules governing the transfer of those entitlements, but to alter the deprivation quantum. If a predatory group can alter the deprivation quantum so that the normal rules of law apply as expected until you reach the stage of penalization, then it could be an effective and difficult-to-identify method of predation.

The deprivation quantum plays an important role in regulating conduct. Suppose the potential defendant engages in an activity from which he gains $1000 per transaction with a potential victim, and risks imposing an injury on a victim of $100 per transaction. The potential defendant/injurer can spend $20 in precaution to reduce the likelihood of imposing the $100 injury in transaction. Suppose that if the injurer spends $20 in precaution, the likelihood of the $100 injury falls from seventy-five percent to twenty-five percent. The value of the risk reduction due to precaution is therefore $50.\(^{41}\)

Suppose the transfer rule imposes strict liability for unintentional harms, and punitive damages are reserved for a special class of malicious harms involving intentional injury of the victim. If the deprivation quantum is set at $100, then it will provide an incentive for the potential defendant to take care (i.e., invest $20 in precaution) to avoid imposing a harm of $100 on a potential victim. To see this, note that if the injurer does not invest in precaution, his expected liability in the typical transaction is $75. If he does invest $20 in precaution, his expected liability is only $25. He will therefore prefer to spend $20 in order to avoid paying an additional $50 in liability. Thus, when the deprivation quantum is set at $100, it provides economically optimal incentives for care.

If the deprivation quantum is set at $4000, then it will wipe out all gains to the defendant from transactions and discourage his activity. To see this, suppose the defendant spends $20 in precaution. In this case, his expected liability is $1000 when the deprivation quantum is set at $4000.\(^{42}\) Since his expected liability ($1000) is equal to his gain from

\(^{40}\) U.S. CONST. amend. V.
\(^{41}\) Moreover, I will assume that the risk imposed on the victim is not apparent ex ante to the victim. Thus, the victim cannot take the risk into account in any price he pays for the transaction (if the transaction is a contract).
\(^{42}\) His expected liability is equal to the probability of an injury to the victim, 25 percent, multiplied by the deprivation quantum, $4000.
the transaction ($1000), the potential defendant will have no incentive to engage in the transaction.43

If the deprivation quantum is set at $1, the potential defendant will take too little care from a welfare perspective, imposing excessive losses on victims. Knowing that he will only be held liable for $1 if the victim is injured, the potential defendant will never invest in precaution, and always act in a manner that imposes a risk of a $100, with likelihood of seventy-five percent, on the victim in each transaction.

In this example, we can see concrete ways in which the deprivation quantum can be used to effect a taking. If the deprivation quantum is set at $1, then there is a wealth transfer from the potential victim to the potential defendant. The potential injurer is wealthier, and the potential victim is poorer. The victim who suffers an injury is obviously poorer because he receives $1 in damages while he suffers a loss of $100. But potential victims as a class are worse off because the potential injurer takes less care in his activity, imposing injuries at a far greater rate on potential victims. This is the larger and more important sense in which they are made poorer by a rule capping their damages at $1.

If the deprivation quantum is set at $4000 for all injuries, then the potential injurer will be discouraged from his activity. This results in a wealth transfer from potential injurers to potential victims. The injurer who imposes a loss on a victim and then is forced to pay $4000 as compensation for an injury whose real cost is $100 is clearly poorer than if he were required to pay exact compensation. However, potential injurers as a class are poorer because the cost of engaging in their activity are much higher, discouraging them from the activity. This argument is also valid if the deprivation quantum is set at any amount above $100.

The optimal rule imposes a penalty of $100 for the typical injury and $1000 (or greater) only if there is evidence of malicious conduct. Malicious harms involve intentional injury of the victim; injuries that will occur with a probability of one hundred percent. In these cases, a penalty of $1000, which wipes out the gains from the transaction, should be sufficient as a deterrent.44

A rule setting the penalty at $100 for the typical (nonmalicious) injury and $1000 for malicious harms gives the potential injurer appropriate incentives to take care and at the

43 Technically, he is indifferent as to the transaction. If the deprivation quantum is set at $4001, the potential defendant will avoid the transaction.

44 I have offered a highly simplified general description of a transaction that could give rise to a claim for liability for failing to take care or for intentional harm. A more defensible version of the model probably would allow the injurer to earn a greater gain for imposing the intentional harm. For example, suppose the injurer is selling widgets. The injurer/seller can invest in care in detailing the characteristics of the widget, or he can fraudulently misstate the risks. If he invests in care, he spends $20, and gets a sales price of $1000. He can engage in fraud more cheaply, and earn a sales price of $2000. In this description, a minimum penalty of $2000 would be required to wipe out the gain from fraud. If the penalty is set at $4000, it will eliminate the activity of selling widgets, which is an undesirable outcome. The version of the model in the text, in which the decision to engage in an intentional tort does not affect the transaction price, might be appropriate for a case of pure theft, such as the case where the injurer/seller simply takes the victim/buyer’s money without providing a widget in return.
same time discourages malicious conduct by eliminating the gains from it. The optimal rule does result in wealth transfers. However, these are of secondary importance to its regulatory function. The total wealth of society is greater under the optimal rule than under the alternatives.

There is a clear link between the protected status of entitlements and the deprivation quantum. If the deprivation quantum is set too high, it strips away the entitlement of potential defendants to engage in legitimate activities. If the deprivation quantum is set too low, it takes away from potential victims their entitlement to protection under the law from negligent and malicious (direct and intentional) injuries.

I have referred to positive and negative restrictions, and they can be illustrated in the damages context. First, consider the positive restriction approach. Suppose a legislature enacts a law requiring cigarette manufacturers to pay $100 billion in compensatory damages “for any harm that befalls a smoker directly attributable to his consumption of cigarettes”. This is a taking. If the Supreme Court were to take a hands-off approach on the theory that states should be permitted to govern their own legal processes, this would be inconsistent with the Due Process Clause as envisioned here because it would permit interest groups to seek statutes that impose wealth-confiscating penalties on target industries. Since the purpose of the clause is to obstruct predatory conduct, the clause requires a reviewing court to strike down such a statute as unconstitutional. It follows that the Court’s decision to apply due process reasoning to punitive damages is defensible as a general matter.

Now, suppose instead of a statute, a state develops through its common law a rule that in a trial between a smoker and cigarette manufacturer, the court will determine by flipping a coin whether the cigarette manufacturer will be required to pay a compensatory award of $100 billion. Here, it is unclear how a legislative faction could have convinced the state courts to adopt such a rule. Still, the rule appears on its face to be so arbitrary in its punishment that it strongly suggests the backing of a predatory hand. With such circumstantial evidence of predation, a court should feel bound by the Due Process Clause to strike down the state’s procedure governing damages in cases involving cigarette manufacturers.

There is also a negative component to the substantive due process analysis. Suppose the state enacts a statute that limits damages to a smoker, in an action against a cigarette manufacturer, to 5 cents. Such a damages cap would reduce incentives on the part of manufacturers to monitor the quality of their products or to take care in the manufacture and selling process. This is destructive of individual entitlements to health and safety because cigarette manufacturers, aside from the reputation-market constraint, would now be unwilling to spend more than 5 cents in order to avoid an injury to a potential victim.

Alternatively, consider the traffic accident setting. Suppose a legislature passes a law that caps damages at $1 for defendants who own luxury cars. This is a transfer of wealth from people who do not own luxury cars to people who do. Moreover, it greatly reduces

45 For analysis of incentives and damages, see Hylton, supra note 8.
incentives of luxury car owners to take care, which diminishes the individual’s entitlement to safety and security. Under the theory of this paper, it is a violation of the due process requirement. If a state’s common law were to arrive at the same conclusion that also should be a violation of due process.

2. Takings and Damages: Pragmatic Considerations

It should be clear that in an attempt to review damages or penalties on due process grounds it might be difficult for a court to distinguish an optimal deterrence scheme from a predatory wealth transfer. A court or legislature might justify an upper or lower bound on the deprivation quantum by referring to imperfections in the judicial process that can be cured only by putting constraints on damage awards. Any effort to use the Due Process Clause to regulate predation through the deprivation quantum requires reviewing courts to distinguish desirable regulation from predation.

Return to some of the earlier examples. A state legislature passes a statute requiring cigarette manufacturers to pay no less than $100 billion in damages to a smoker who prevails in litigation. Alternatively, and perhaps more realistically, suppose a legislature passes a statute limiting damages in medical malpractice cases to $500. I have argued that these examples suggest the backing of predatory hand, and should be struck down on due process grounds, unless some strong evidence exists to prove that these constraints are part of a socially desirable regulatory scheme. Let us examine these examples more closely.

In the case of the $500 cap on damages in malpractice cases, a legislature might justify it on the ground that juries have tended to be too generous to plaintiffs, and that high tort judgments discourage physicians from entering the state to practice. Alternatively, in the case of the $100 billion lower bound on damages, a legislature might justify it on the ground that juries have tended to be too stingy to plaintiffs, and it is therefore necessary to constrain courts in order to provide appropriate levels of compensation and deterrence. In both cases, the proffered justification might appear to be reasonable. Why, then, would I argue that both examples suggest the backing of a predatory hand?

The problem in both cases – the $100 billion lower bound and the $500 upper bound on damages – is that they constrain courts from adopting reasonable regulatory schemes under tort law. A $100 billion lower bound on damages effectively would prohibit the activities subject to the damages awards, while having no impact on caretaking incentives. Similarly, a $500 upper bound on damages would severely reduce caretaking incentives of potential defendants. Unless the state introduced some alternative regulatory scheme to control entry and precaution decisions, the damage constraints in these examples would eviscerate the regulatory capacity of tort law.

When a constraint on the deprivation quantum has a wealth-transferring effect and at the same time appears to severely distort or eviscerate the regulatory capacity of existing tort law, it is appropriate to infer that the constraint serves largely a wealth-transferring effect. In other words, it is rational to infer the backing of a predatory hand, or equivalently a
taking, when the deprivation quantum constraint destroys the regulatory function of the law and enriches one identifiable class of litigants at the expense of another.

The best that can be done at this stage is to define the legal inquiry as an effort to determine whether the constraint strongly suggests the backing a predatory hand. Obviously, it will be impossible for reviewing courts to identify every case in which constraints have been imposed in order to transfer wealth. However, a rule that at least permits courts to cancel predatory constraints serves as general deterrent to rent-seeking efforts to modify the deprivation quantum.

B. Due Process and Recidivist Injurers

Suppose a recidivist injurer takes $100 from each of his victims. However, only one of every two victims brings a suit. What is the proper level for the deprivation quantum? If the deprivation quantum is set at $100, the recidivist injurer will be able to keep $100 of every $200 that he takes. He will therefore find the taking business profitable, and will continue in it. In order to protect the entitlements of victims, the deprivation quantum should be set at $200 for each lawsuit. This amount would remove the profits from taking. This requires the use of a multiplier of 2 applied to the damages for every victim who wins his lawsuit against the injurer. A multiplier less than 2 would result in repeated takings against victims, and would fail to protect their endowments.

The multiplier has been a central concern of the Supreme Court’s case law on punitive damages. Instead of referring to a multiplier, however, courts have referred to the ratio of the punitive to the compensatory award. BMW v. Gore46 required a reasonable relationship between the punitive and compensatory award, without suggesting a specific numerical limit.47 State Farm continued with the general doctrine of Gore, but added in dicta the claim that a ratio that is greater than a single digit should be considered questionable on constitutional grounds.48 Some courts have referred to the single-digit ratio statement of State Farm as if it were a rigid standard in due process law.49

47 Id. at 585 (“[W]e are not prepared to draw a bright line marking the limits of a constitutionally acceptable punitive damages award.”).
48 State Farm Mut. Ins. v. Gore, 583 U.S. 408, 425 (“Our jurisprudence and the principles it has now established demonstrate . . . that, in practice, few awards exceeding a single-digit ratio between punitive and compensatory damages, to a significant degree, will satisfy due process.”)
49 See, e.g., Eden Elec. Ltd. v. Amana Co., L.P., 258 F.Supp.2d 958 (N.D. Iowa 2003). In Eden the court read State Farm to mean that “even where all the reprehensible considerations are present, but where compensatory damages are significant, the punitive damages award ordinarily cannot exceed the 10-to-1 ratio and still be constitutional.” Id. at 974. Other courts, though acknowledging that State Farm declined to impose a bright-line limit as to a constitutionally acceptable ratio of punitive damages to actual damages, have spoken approvingly of the single-digit ratio. See, e.g., Campbell v. State Farm Mut. Auto Ins. Co., 98 P.3d 409, 418 (Utah 2004) (concluding that “a 9-to-1 ratio between compensatory and punitive damages . . . serves Utah's legitimate goals of deterrence and retribution within the limits of due process.”); Vasquez-Lopez v. Beneficial Oregon, Inc., 152 P.3d 940 (Or.App. 2007) (approving a ratio of 1.5:1); Environmental Energy Partners, Inc. v. Siemens Bldg. Technologies, Inc., 178 S.W.3d 691, 708 (Mo.App. S.D. 2005) (finding a ratio 4:1 of punitive damages to compensatory damages to be acceptable, while implying that a ratio of 19:1 may not be acceptable); Bocci v. Key Pharmaceuticals, Inc. 76 P.3d 669, 675 (Or.App. 2003) (striking down a punitive damages award ratio in excess of 10:1 and stating that the court should ask the
The single digit ratio standard of *State Farm* fails to protect the endowments of potential victims. Return to my example of the recidivist injurer and change the assumptions so that he takes $100 from each victim, and only one victim out of twenty brings a suit. The proper multiplier is twenty. Setting the multiplier at a lower level would permit the recidivist injurer to profit from his activity and guarantee its continuance.

If the single digit ratio standard had been enacted as a state statute, it would be questionable on due process grounds because it would suggest (although weakly) the backing of a predatory hand. The single digit ratio standard enacts a soft cap on damages that transfers wealth from potential plaintiffs to potential defendants. Moreover, the ratio cap could prevent damages from serving a desirable regulatory function. The cap would be no less suggestive of the backing of a predatory hand if it had been adopted by a state court.

*Philip Morris* implies that the multiplier in my example of the recidivist injurer cannot be set above 1. The theory supporting this decision is that every victim should bring his own claim to court, and the defendant should not be penalized for harms imposed on victims who are not in court. However, there are cases in which victims suffer an injury and cannot identify the injuring party or the source of the injury. The victims who cannot identify the injurer or the source of the injury will never bring suit.

As this example suggests, *Philip Morris* is a flawed application of due process doctrine. In order to protect against the risk of a penalty that is excessive, the Court held that any direct attempt to apply a multiplier in recognition of harms to other victims is itself a violation of due process. This results in an interesting paradox. The decision seems to require penalties against recidivist injurers to be set at a level that fails to protect the entitlements of potential victims, which suggests that the decision itself is a violation of due process. It removes the disincentive from recidivist wrongdoing, and thereby transfers wealth from potential victims to recidivist injurers. This is a contradiction of the traditional function of substantive due process analysis, which has been to offer expansive protection to entitlements from predatory takings.

question “whether there are circumstances present in this case that would justify a ratio higher than 4 to 1.”

The *Vasquez-Lopez* court approved an award of 1.5:1 of punitive damages to potential damages, though the ratio of punitive damages to actual compensatory damages was much higher. *Vasquez-Lopez*, at 958. The court’s focus on potential damages seemed designed to bring the ratio within the single digit constraint.

50 The court explains that procedural due process requires that the defendant have the opportunity to defend against every claim brought against him but a defendant has no chance to defend against a non-party victim. *Philip Morris*, 127 S. Ct. at 1063. Therefore, since the only damages that may be awarded are for the plaintiff’s injuries, the multiplier is 1.

51 *Philip Morris*, 127 S. Ct. at 1063.


53 I say that the decision “seems” to impose a strict constraint because it is not entirely clear that it does. As I noted earlier, *Philip Morris* permits courts to increase punitive awards on the basis of reprehensibility, which is a function of (among other things) the number of real or potential victims of the defendant’s conduct. This suggests that a court could apply a damages multiplier on the basis of harms to victims other than the plaintiff, and justify the multiplier on the basis of a reprehensibility analysis.
Even if Philip Morris were not so deeply flawed, the Court’s decision to apply due process theory to the deprivation quantum remains a risky and uncertain undertaking. To do so consistently, the Court would have to identify instances in which the deprivation quantum is set too high from a social perspective and also instances in which the deprivation quantum is set too low from a social perspective. It is a serious indictment of the Court’s reasoning that it has not articulated a theory for identifying either instance. It is yet another indictment that the Court has found reasons to worry only in cases in which it thinks the deprivation quantum is set too high from a social perspective. However, a taking can just as easily occur through the deprivation quantum being set too low from a social perspective. Indeed, the paradox of Philip Morris is that in order to avoid the case in which the deprivation quantum is set too high, it appears to require the deprivation quantum to be set too low, which preserves and enhances the risk of a taking (though in a different direction than the Court envisioned).

In view of the uncertainties, the Court would be on much stronger ground if it limited its application of substantive due process analysis to cases involving the scope of constitutionally protected entitlements (procedural due process analysis already governs the transfer process question). In general, substantive due process appears to be a potentially applicable theory to the problem of entitlements and to the problem of the deprivation quantum. However, with respect to the deprivation quantum, the Court will always find itself on shaky ground. It will be in the position of second-guessing other courts that have had more time to consider their own common law rules governing damages and the appropriateness of applying those rules in specific cases. The Supreme Court has no particular advantage in determining an excessive damage award from one that is optimal on deterrence grounds. It can identify extreme cases. But damage levels that are within the range of appropriate damages would appear to be beyond the Court’s expertise to reevaluate. And if a state court has developed a reasonable set of procedures for determining punitive awards, it is unlikely that the result of that procedure will be obviously excessive in light of the relevant substantive due process concerns.

Alternatively, given that the language of the Due Process Clause invites an inquiry into the deprivation quantum, the Court should forge ahead while recognizing the difficulties it faces in assessing whether a specific deprivation quantum is a taking rather than a socially desirable penalty. In order to make such an assessment, a court will have to at least consider the incentives created by the deprivation quantum. Perhaps by adopting the approach suggested in the previous part of this paper, in which the Court would look for instances in which the quantum determination strongly suggests the backing a predatory hand, it can distinguish takings from socially desirable penalties. However, the creation of simplistic axioms, such as the Philip Morris proposition that it is wrong to increase damages to A in order to reflect harms to B, falls far short of providing a serious

---

54 Consider for example, Justice Breyer’s second-guessing of the Green Oil factors, see BMW of North America v. Gore, 517 U.S. 559, 589-593 (Justice Breyer concurring).
55 See Hylton, supra note 8.
analysis of the welfare implications of a particular approach to determining the deprivation quantum.

As I noted before, the Philip Morris opinion uses the language of procedural due process in a manner that suggests a retreat from the path of recent decisions applying substantive due process analysis to punitive damages. The use of procedural due process language is arguably reassuring in the sense that it may signal a retreat to the procedural due process approach. However, the use of procedural due process language in Philip Morris was somewhat inappropriate and at worst insincere. After all, Philip Morris puts a weak substantive limit on the deprivation quantum. It holds that the deprivation quantum should not be deliberately designed to include a component that reflects a penalty for harms done to victims other than the plaintiff. That message has nothing to do with procedural due process; it is a substantive limit on the deprivation quantum. Of course, it is a weak substantive limit, because Philip Morris permits courts to evade that limit by focusing entirely on reprehensibility as a basis for awarding punitive damages. But it is a substantive limit nonetheless and in that respect it is incorrect to suggest that it is entirely a function of procedural concerns.

C. Due Process and Class Actions

In the case in which the recidivist injurer takes $100 from each victim and only one victim out of twenty brings suit, a class action would be the obvious alternative to a single lawsuit resulting in a multiplier of twenty. A lawsuit brought by a class of twenty or a single lawsuit resulting in a total award of $2000 would accomplish the same deterrence objective. Both approaches would uphold the law’s efforts to protect the endowments of potential victims from systematic predation.

The rationale of Philip Morris, stretched to its logical endpoint, implies that the class action device is impermissible on constitutional grounds. Philip Morris stresses the defendant’s entitlement on due process grounds to mount a defense against every individual claim for punishment. Although the Court did not say that class actions are unconstitutional, the rationale of Philip Morris will be used by defendants to contest class certification.

Clearly, it is possible for the class action device to be used as a form of predation against potential defendants. It is also possible for restrictions on the device to be used to support private predation, by disarming potential victims of an effective tort remedy. Due process reasoning should be used to prevent both types of predation.

In the class action setting, the key method of predation against potential defendants involves the formation of classes that effectively bundle claims that have insufficient

56 Pacific Mut. Life Ins. Co. v. Haslip, 499 U.S. 1 (1991) The Supreme Court stated that “every state and federal court that has considered the question has ruled that the common-law method for assessing punitive damages does not itself violate due process . . . In view of this consistent history, we cannot say that the common-law method for assessing punitive damages is so inherently unfair as to deny due process and be per se unconstitutional.” Id. at 17.
legal merit to result in any punishment against the defendant. It is easy to see the ways this can occur. The plaintiff class may include individuals who suffered no injury at all, or whose injuries are not due to the defendant’s conduct. A system of procedural rules that permits litigation classes that bundle such fictitious claims would enable predation against potential defendants. Conversely, a system of procedural rules that prohibits the formation of valid classes, or the use of punitive multipliers to bring about socially desirable deterrence, would enable predation by potential defendants.

Due process reasoning should be used not to eliminate class actions but to regulate the class action device in order to prevent predation either by plaintiffs or by potential defendants. The requirement of commonality among claims in class actions is an important method of preventing abusive class actions. In general, the goal should be to prevent classes being formed on the basis of heterogeneous claims and to prevent redundant penalization. Rules that serve this function in the class action context should be imported to the punitive damages case law to ensure that plaintiffs cannot use the punitive damages lawsuit to achieve objectives that are barred under the rules governing class actions. This implies that if a court were to hold that a proposed class is inappropriate for certification, a punitive damages claim based on the same hypothetical class should also be rejected.

III. Conclusion

What I have tried to do in this paper is develop an economic theory of the function of the Due Process Clause and to use that theory to understand the relationship between due process concerns and civil damages. The key concerns generated by the due process clause are three: the scope of protected entitlements, the transfer rules governing those entitlements, and the deprivation quantum. Substantive due process analysis seems to be applicable to the question of entitlements and to the deprivation quantum. The transfer rules are obviously a matter of procedural due process.

In general, one can distinguish between expansive and contractive substantive due process analysis. The expansive approach is preferable because it blocks predatory legislative grabs, which appears to be consistent with the Lochner case law. The expansive versus contractive distinction is less useful in the context of the deprivation quantum because this is really a matter of increasing or reducing a penalty. Increasing it benefits those whom the penalty is designed to protect; lowering it benefits those the penalty is designed to regulate. Still, in many cases there will be an optimal penalty, or range of penalties, that is best from society’s point of view, because it protects potential victims without over-deterring potential injurers. Any application of due process analysis that prevents a state from levying an optimal penalty is harmful to society’s welfare.

---

The theory developed here suggests that substantive due process analysis is quite difficult to apply with any degree of accuracy and consistency to the deprivation quantum. Courts probably would do best to reserve substantive due process analysis to determination of the scope of protected entitlements. Alternatively, courts should be prepared to consider the incentive effects created by the deprivation quantum, in order to distinguish takings from punishment consistent with reasonable regulation.

On the assumption that courts will continue to apply due process reasoning to the deprivation quantum, this paper has suggested guidelines for distinguishing predation from reasonable regulation in the context of punitive damages. One general guideline is that if the punitive award both effects a substantial wealth transfer and is inconsistent with reasonable regulation, then it is potentially a taking. However, the mere fact that the punitive award is large, or a multiple-digit ratio of a compensatory award, or could be interpreted as internalizing harms suffered by non-plaintiffs, is of no importance, in a takings analysis, in the absence of some consideration of the incentive effects created by the award.