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EXEMPLARY DAMAGES IN EQUITY

by

Anthony Duggan

“If a man shall steal an ox, or a sheep, and kill it, or sell it; he shall restore five oxen for an ox, and four sheep for a sheep”1

1. Introduction

In Harris v. Digital Pulse Pty Ltd,2 (“Digital Pulse”), the New South Wales Court of Appeal by a majority (Spigelman CJ and Heydon JA, Mason P dissenting) held that exemplary (or punitive) damages3 are not available for breach of fiduciary duty or other equitable obligation.4 The decision runs counter to authorities in Canada,5 New Zealand,6 and some American states.7 In England, the availability of exemplary damages in equity

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2 (2003) 56 NSWLR 298
3 “Exemplary damages” is the preferred term in most Commonwealth countries. “Punitive damages” is the preferred term in the United States and Canada. Opinions differ over the choice of terminology. See Broome v Cassell & Co. [1972] 2 AC 1072 at 1073 per Lord Hailsham (preferring “exemplary damages”) and 1124 per Lord Diplock (preferring “punitive damages”). In Australia, the High Court has sided with Lord Hailsham: Gray v. Motor Accident Commission (1998) 196 CLR 1. On the other hand in England, the Law Commission has sided with Lord Diplock: Aggravated, Exemplary and Restitutionary Damages (Law Com. No. 247, 1997), para. 5.39.
4 Strictly speaking, the decision is limited to the case where the defendant’s breach of fiduciary duty is also a breach of contract: Digital Pulse (2003) 56 NSWLR 298 at para 5 per Spigelman CJ and see David Morgan, “Harris v. Digital Pulse: The Availability of Exemplary Damages in Equity” (2003) 29 Monash University Law Review 377 at 384-385. However, the decision is strong persuasive authority, in New South Wales, at any rate, for the proposition that exemplary damages are not available in equity at all.
7 E.g., IHP Corp. v. 210 Central Park South Corp. 228 NYS 2d 883 (1962).
is unsettled.\textsuperscript{8} However, the Law Commission has recommended that the remedy should be available.\textsuperscript{9}

There were two issues in Digital Pulse: (1) does New South Wales law as it presently stands permit an award of exemplary damages in equity? and (2) if not, should the court change the law? The majority answered both questions in the negative. The answer to the second question was based not primarily on considerations of policy but, rather, on considerations of judicial competence: in the majority’s view, an intermediate court of appeal lacked the capacity to make changes of this kind. Any such change was a matter for either the High Court or the legislature. Nevertheless, policy considerations are not far from the surface, particularly in Heydon JA’s judgment. There are clear indications in the judgment of his opposition to changing the law as a matter of policy. Furthermore, his judgment in parts can be read as suggesting that exemplary damages are a bad idea, not just in equity, but at common law as well. Alan Beever, in an article published shortly before the decision in Digital Pulse was handed down, advanced just such a proposition, arguing that exemplary damages at common law should be abolished.\textsuperscript{10} Beever’s arguments echo points Heydon JA makes in his judgment. On the other hand, David Morgan, writing in the wake of Digital Pulse, supported Mason P’s minority position. In Morgan’s view, the court should have confirmed the availability of exemplary damages


\textsuperscript{9} Ibid. paras 5.54-5.56.

in equity and it should have upheld the trial judge’s award of exemplary damages to the plaintiff.

Punitive (exemplary) damages is a hot topic in the United States, particularly in the tort litigation context, and it has attracted considerable interest among law and economics scholars. Neither Beever nor Morgan refers to the law and economics literature. Nor do any of the judgments in Digital Pulse. The aim of this paper is to examine Digital Pulse from a law and economics perspective, drawing on the literature just mentioned and in particular Polinsky and Shavell’s leading contribution. The conclusions the paper will draw are as follows: (1) exemplary damages should be available in equity, but on a limited basis only; (2) exemplary damages were probably not warranted in Digital Pulse itself; and (3) given the complexity of the question, the Court of Appeal was right to defer to the High Court and the legislature on the availability of the remedy. Part 2, below gives a descriptive account of Digital Pulse. Part 3 explains the economic case for exemplary damages. Part 4 analyses Digital Pulse and other cases by reference to the considerations Part 3 identifies. Part 5 discusses a number of subsidiary issues. Part 6 concludes.

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2. The *Digital Pulse* case

The facts of *Digital Pulse* are simple and familiar. The case is in the *Cook v. Deeks*\(^{12}\) mould. The plaintiff company (P) carried on a business of providing computer-based multi-media services to clients. The defendants (D1 and D2) were P’s employees. It was a term of their contracts of employment that they would not compete with P so long as P employed them. D1 and D2 decided to leave P’s employment and set up business on their own. They formed their own company, Juice-D Media Pty Ltd (“Juice”) and they worked secretly for Juice while they were still employed by P, using their positions to divert business from P to Juice. P sued D1 and D2 for breach of contract and breach of fiduciary duty, among other things. It claimed compensation, an account of profits and exemplary damages. The trial judge found D1 and D2 liable in contract and also for breach of fiduciary duty. He awarded P compensation and alternatively, at P’s election, an account of profits. P elected to take the account of profits which were calculated at just over $13,000.\(^{13}\)

In addition, the trial judge awarded P exemplary damages of $10,000 each against D1 and D2. He said that the purpose of exemplary damages was: “to punish the wrongdoer for reprehensible conduct; to deter not only the wrongdoer but others of like mind in the

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\(^{12}\) [1916] AC 554 (JC)

\(^{13}\) Profits were calculated on the basis of the gross profits actually received by Juice from diverted projects, less provision for tax. Compensation was to be calculated on the basis of determining the gross amounts charged by Juice in the invoices it sent to the wrongly diverted customers and applying to those figures the profit margins that P would have realized had it carried out the work, less tax. The compensation, calculated on this basis, would have worked out at just under $10,000: *Digital Pulse* (2003) 56 NSWLR 298 at paras 71 and 72 per Mason P.
community from similar conduct; [and] to ameliorate the victim’s sense of grievance and thereby to abate the urge for self-help or violent retribution, to the danger of the public peace”. The judge awarded P exemplary damages specifically on the following grounds: (1) D1 and D2’s wrongdoing was calculated both to produce profit for themselves and cause harm to a vulnerable employer; (2) their subversion of P’s business for Juice’s benefit was carefully planned; (4) they exulted in their success at having diverted one project in particular from P; (5) there was a strong inference that D1 and D2 had diverted more business from P than the evidence actually revealed; (6) their conduct included the misappropriation of confidential information; and (7) they spent a great deal of time for which P was paying them in attending to Juice’s affairs. The judge summarized by saying that “all of these circumstances, taken together, demonstrate deliberate wrongdoing for profit, in contumelious disregard of [P’s] rights, deserving of special condemnation and punishment”. D1 and D2 appealed against the exemplary damages award.

In the Court of Appeal, Spigelman CJ held that exemplary damages cannot be awarded for a breach of fiduciary duty which is also a breach of contract because in Australia exemplary damages are not available for breach of contract and it would be anomalous if P could claim exemplary damages for the identical conduct by suing for breach of fiduciary duty instead. He also held that there was no precedent for the awarding of exemplary damages in equity and “no process of deduction, induction or analogy by the

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14 Quoted in Digital Pulse (2003) 56 NSWLR 298 at para. 242 per Heydon JA.
15 Ibid. paras 245-251.
16 Ibid. para. 252.
application of a permissible method of judicial reasoning which can lead to that result”.17 Furthermore, he said, exemplary damages are inconsistent with equity because “equity is concerned with the conscience of both parties, so that a balancing exercise is always required”.18 By contrast, exemplary damages impose a penalty on the defaulting fiduciary and confer a corresponding windfall on the plaintiff.19

Heydon JA held that exemplary damages were inconsistent with equity because equity does not punish. It is true that equitable remedies may perform a prophylactic function, but that is not the same as punishment. Furthermore, he said, there is no precedent for the award of exemplary damages in equity. The authorities and secondary literature P relied on in support of its case for exemplary damages all turned out, on inspection, to be statements of what the law should be and not what it currently is in New South Wales. An intermediate court of appeal lacked the competence to make the kind of change in the law that would be required for P’s case. Heydon JA also made a number of policy observations relevant to exemplary damages at large. Quoting from Broome v. Cassell & Co. Ltd,20 he suggested that punitive damages are problematic because they confuse “the function of the civil law which is to compensate with the function of the criminal law which is to inflict deterrent and punitive penalties”.21 “There is much to be said against a system under which a fine becomes payable in a civil court without any of the safeguards which protect those charged with crimes”.22 Exemplary damages attach criminal

18 Ibid. para.52.
19 Ibid. para.53.
22 Ibid. para. 351.
sanctions to conduct which is not otherwise necessarily criminal. They therefore attract
the same objections as the creation by courts of new crimes.\textsuperscript{23} Exemplary damages raise
logistical problems. What if there is a criminal prosecution: if the criminal prosecution
comes first, should the judge in the civil action take the criminal penalty into account in
deciding on exemplary damages? If the civil action comes first, should the judge take the
possibility of a later criminal prosecution into account when deciding on exemplary
damages and should the judge at the criminal trial take an exemplary damages award into
account in sentencing?\textsuperscript{24}

Mason P., dissenting, found that there was no general doctrine to the effect that equity
lacks the power to punish. On the contrary, “Equity reveals itself readier to select a more
stringent remedy if the fiduciary’s fault is deserving of punishment, for example if it was
deliberate and/or motivated by greed”.\textsuperscript{25} Punishment in this context includes both
retribution and deterrence and there is no authority for desegregating these two
functions.\textsuperscript{26} Mason P. also argued that breach of fiduciary duty is more closely analogous
to tort than contract and, given that exemplary damages are available in tort, it would be
anomalous if they were not also available in equity for the same conduct.\textsuperscript{27} Courts in
other common law jurisdictions have awarded exemplary damages for breach of fiduciary
duty and New South Wales should follow suit. The question was not such a novel one
that it fell outside the authority of an intermediate court of appeal to determine.\textsuperscript{28} An

\textsuperscript{23} Ibid. para. 349.
\textsuperscript{24} Ibid. para. 352.
\textsuperscript{25} (2003) 56 NSWLR 298 at para. 166.
\textsuperscript{26} Ibid. para. 171.
\textsuperscript{27} Ibid. para. 185.
\textsuperscript{28} Ibid. paras 217-224.
award of exemplary damages is not tantamount to the creation of a new criminal offence.\textsuperscript{29}

3. **The law and economics perspective**

(a) **The various functions of exemplary damages**

There are at least three functions an exemplary damages award might perform:\textsuperscript{30} (1) compensation; (2) retribution; and (3) deterrence. The compensation rationale is incoherent, at least in the form it is usually presented.\textsuperscript{31} Exemplary damages are by definition extra-compensatory and so they cannot serve a compensation function. If the goal really is compensation, then the damages are compensatory damages, not exemplary damages.\textsuperscript{32} One of the reasons the trial judge in *Digital Pulse* gave for awarding P exemplary damages was that D1 and D2 may have diverted more business from P than the evidence actually revealed. In other words, one purpose of the exemplary damages award was to top up P’s compensation. That cannot be right. Calling P’s compensatory damages by another name does not make the evidentiary problem go away. If the evidence supports P’s claim to the amount in question, then the court should award P the

\textsuperscript{29} *Ibid.* para. 227.
\textsuperscript{31} But see Catherine M. Sharkey, “Punitive Damages As Societal Damages” (2003) 113 *Yale Law Journal* 347, arguing that punitive damages serve a societal compensation goal: the redress of harms caused by defendants who injure persons beyond the individual plaintiffs in a particular case.
\textsuperscript{32} See Beever, *op.cit.*
amount by way of compensatory damages. If the evidence does not support P’s claim, then the court should not award P the amount at all.33

Retribution means punishment. The concern is to make sure that wrongdoers receive their just deserts. The key requirements for punishment are: (1) blameworthiness; and (2) proportionality. The punishment must fit the crime.34 From a retributive perspective, the goal of exemplary damages is to ensure that the court’s judgment reflects the community’s sense of outrage at D’s wrongdoing. Two factors are likely to loom particularly large in the court’s assessment of D’s blameworthiness: (1) D’s state of mind; and (2) the degree of harm caused or likely to be caused by D’s conduct.35 The first consideration is particularly important. It picks up on the intuition that “certain intentional states of mind are especially blameworthy because they reflect abhorrent and false views about the moral worth of persons.”36 “Retribution, properly understood, embodies a principle of moral equality”.37 In the Digital Pulse case, the trial judge emphasized: (1) D1 and D2’s dishonesty; (2) the calculatedness of their wrongdoing; and (3) the illegitimate pleasure they gained from the success of their scheme. These factors are all consistent with the retributive function of exemplary damages.

33 See Polinsky and Shavell, *op. cit.* 939-941.
35 Ibid.
36 Ibid. 2086.
37 Ibid.
The law and economics literature by and large favours exemplary damages, but for reasons of deterrence rather than compensation or retribution. The argument runs as follows. From an economic perspective, the goal of tort law and the law of civil wrongs generally is to make D internalize the social harm of D’s conduct. Internalization of the costs of wrongdoing aligns D’s personal interests with the interests of society at large. Faced with the prospect of being held liable for the amount of harm D’s conduct causes others, D will proceed with the conduct if, and only if, the benefits to D personally exceed the costs of the conduct to others. A damages award against D serves not only to compensate P but also to deter D in the manner just described from engaging in socially harmful conduct. This deterrence function works well only if the probability of a successful suit against D is 1. If the probability is less than 1, D will still have an incentive to proceed with the conduct in question, even though the social costs of the conduct exceed its social benefits. There are various reasons why the probability of a successful suit against D may be less than 1, for example: (1) P may be unable to prove that she was wrongfully harmed; (2) P may be unable to prove that D was the wrongdoer; or (3) litigation costs may make it uneconomical for P to sue D, particularly if the amount at stake is small or there is a low likelihood of proving causation. The function of exemplary damages is to achieve optimal deterrence in cases where for any of these reasons the probability of a successful suit is less than 1.

38 See the references in n.11, above.
(b) Calculating exemplary damages

It follows from what has just been said that, for deterrence purposes, total damages should equal the amount of P’s loss in a particular case multiplied by the inverse of the probability that P will successfully sue D. On this basis, exemplary damages are the excess of total damages over compensatory damages. Polinsky and Shavell, among others, argue for a punitive (exemplary) damages regime along these lines. They say that punitive damages calculated using the multiplier formula should be imposed in all cases where for any of the reasons identified above the probability of a successful suit is less than 1. Punitive damages may also be justified in cases where D’s wrongdoing gives rise to gains that are not counted in social welfare, even if there is no chance that D will escape liability. For example, if D’s conduct is malicious, the illicit pleasure D obtains from harming P may exceed the harm P suffers. If so, compensatory damages will be an insufficient deterrent and a punitive damages award may be needed to cover the shortfall.

The multiplier formula requires the court to determine the ex ante probability that P will successfully sue D. Polinsky and Shavell acknowledge that a court will rarely be able to measure the probability exactly, but they suggest that in most cases it should be possible to come up with at least a rough estimate. In any event, they say, even if the court makes a significant error in estimating the probability, this will not necessarily create a serious problem for achieving optimal deterrence. Provided that courts’ errors are not systematically biased upwards or downwards, D will know that the courts’ assessments
will be approximately correct on average and this should be a sufficient incentive for D to behave properly. The concern about the systematic miscalculation of probabilities may be a more pressing one in the United States, where the question is for the jury to decide, than it is in other countries where jury trials in civil actions are less common. A related concern is that the calculation of exemplary damages using the multiplier formula may be intuitively unappealing, particularly if the formula yields an amount which is out of proportion to the degree of D’s moral blameworthiness. A challenge for proponents of the multiplier formula is to persuade decisionmakers to set aside their retributionist intuitions and to think more abstractly in terms of optimal deterrence. Again, this concern may loom larger in the United States than in other countries where jury trials in civil actions are less common. On the other hand, the recent United States Supreme Court decision in State Farm Mutual Automobile Insurance Co. v. Campbell, which casts doubt on the constitutionality of a punitive damages multiplier, suggests that judges, too, may need convincing.

(c) The case for exemplary damages in equity

In a fiduciary relationship, P (the principal) or T a third party (such as the creator of a trust) entrusts D (the fiduciary) with an enterprise to control and manage on P’s behalf. The enterprise may comprise assets (land, investments and the like) (as in the case of a

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40 In England, the Law Commission has recommended that the judge, and not the jury, should always determine the availability and quantum of exemplary damages: op.cit. paras 5.91-5.98.
trust where D is the trustee and P is the beneficiary), a business (as in the case of a company where D is a director and P is a shareholder) or goodwill (as in the case where P employs D to service P’s clients). The separation of ownership from management and control of the enterprise gives D an incentive to cheat P. The incentive to cheat arises because of the costs to outsiders, including P, associated with monitoring D’s inputs. Monitoring costs are high because D’s management and control of the enterprise gives D exclusive access to information that may be relevant to the assessment of D’s inputs. This means that D’s outputs may be all P and others have to go on as evidence of D’s inputs. However, D’s outputs themselves may be ambiguous to outside eyes in the absence of information about D’s inputs. A loss to the enterprise may signal misconduct on D’s part or it may be just bad luck. Likewise, a gain to the enterprise may occur despite D’s inputs. According to Polinsky and Shavell, the court should award punitive damages in any case where the probability of a successful suit by P is less than 1. Given that in a fiduciary relationship P will always have trouble monitoring D’s performance, it might be tempting to think that exemplary damages should be routinely awarded for breach of fiduciary duty.

Cooter and Freedman explain why this is wrong. Exemplary damages are unnecessary as a general rule because equity has other ways of dealing with the under-deterrence


43 See, e.g., Cook v. Evatt (No.2) [1992] 1 NZLR 676 at 706 per Fisher J.: “where the successful cause of action is breach of fiduciary duty the additional step of demonstrating punishable conduct may be a relatively short one compared with most other classes of action”.
Optimal deterrence depends on two variables: (1) the probability that D will be caught \((p)\); and (2) the size of the penalty D faces if caught \((f)\). The under-deterrence problem can be addressed by raising either \(p\) or \(f\). Equity employs both measures. Equity’s response to the information imbalance between P and D is to assume the worst. As a general rule, D must disgorge personal gains made in the course of office and P does not have to prove that D actually cheated. In the landmark case of *Keech v. Sandford*, D, having failed to obtain the renewal of a lease on P’s behalf, took the lease in his own name. There was no way for the court to know whether D deliberately caused his negotiations on P’s behalf with the landlord to fail so that he could pick up the lease for himself. The court held that proof of D’s intention to cheat was immaterial and it declared a constructive trust of the leasehold interest in P’s favour. The *Keech v. Sandford* rule forces D either to give up all thought of taking the gain for himself or alternatively to disclose to P all relevant information about D’s inputs and obtain P’s consent to the dealing. Shifting the burden of proof to D addresses the under-deterrence problem by raising \(p\).

Moreover, whereas at common law, P’s usual remedy is to claim damages from D as compensation for loss, in equity P typically has the option of suing D instead for the gains D has made from the wrongdoing. P may prefer a gains-based remedy to a loss-based remedy if D’s gain exceeds P’s loss or if P cannot quantify her loss. If D’s gain

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45 (1726) 25 E.R. 223.
46 Equity’s gains-based remedies include: (1) the account of profits; (2) the constructive trust; and (3) the equitable lien. An account of profits is an order for payment of D’s gains from wrongdoing. A constructive trust is an order declaring that D holds the gains from wrongdoing or their traceable proceeds on trust for P. An equitable lien is a judicially created security interest. A court may award P an account of profits or compensation secured by an equitable lien over the gains from D’s wrongdoing or their traceable proceeds.
exceeds P’s loss, a gains-based remedy increases deterrence by raising $f$ as Illustration 1 shows.

*Illustration 1.* Assume that, as in *Keech v. Sandford,* D obtains for himself a contract with T which he was under a fiduciary obligation to obtain for P. P values the contract at $4 and D values it at $7. If $p = 1$, D’s expected gain is $7$. His expected loss is $4$ if P’s remedy is a loss-based one, but it rises to $7$ if P’s remedy is a gains-based one. Consequently, allowing for P’s successful suit it remains economical for D to proceed with the transaction if P is limited to a loss-based remedy, but not if P has the option of a gains-based remedy.

Under-deterrence is an issue for the lawmaker. Over-deterrence, the opposite problem, is just as much a concern. A rule leads to over-deterrence if it causes D to take precautions that cost more than the harm the precautions prevent.\footnote{Polinsky and Shavell, op.cit. 879.} There are two types of error a court might make when it decides a case involving an alleged breach of fiduciary obligation: (1) the court might wrongly conclude that D was honest and uphold the transaction; or (2) it might wrongly conclude that D was dishonest and set the transaction aside.\footnote{Kenneth B. Davis Jr, “Judicial Review of Fiduciary Decisionmaking – Some Theoretical Perspectives” (1985) 80 Northwestern University Law Review 1 at 25-27.} A rule that absolutely prohibited a fiduciary from making gains in the course of office would eliminate the risk of Type 1 errors but it would increase the risk of Type 2 errors. The consequence would be to limit the incentives for D to search out and exploit profitable opportunities, making both P and D worse off.\footnote{Easterbrook and Fischel, op.cit. 441-442.} Equity mitigates this effect by
allowing D to pursue opportunities for himself provided D obtains P’s informed consent and the terms of any exchange between P and D are fair.\(^{50}\) However, D remains exposed to some risk of Type 2 error because, if P ends up suing D, the burden is on D to justify the transaction and the court may wrongly reject D’s justification.\(^{51}\) A simple disgorgement remedy keeps the residual risk of Type 2 errors in check, as Illustration 2 shows.

**Illustration 2.** Assume that in a *Keech v. Sandford*-type case, the value to P of a contract with T is $4, whereas its value to D is $7.\(^{52}\) D is prepared to pay P $4 if P lets D take the contract. D’s costs of negotiating with P and T are $0.30. There is a 1/10 \textit{ex ante} probability that P will end up suing D and that the court will wrongly reject D’s justification of the deal. If the remedy is simple disgorgement, D’s expected loss is $0.03: $0.30 \times 1/10. Her expected gain is $2.70: ($7 - $4) \times (1-1/10). Since D’s expected gain exceeds her expected loss, D is likely to go ahead with the transaction and P and D will jointly benefit.

Contrast the case where the court awards exemplary damages calculated as a multiple of D’s gain, as in Illustration 3.

**Illustration 3.** The facts are the same as in Illustration 2. D’s expected gain is still $2.70. However, her expected loss is now $3.03: $0.03 + 1/10($3 \times 10) and this makes it uneconomical for her to go ahead with the transaction.

\(^{50}\) See, e.g., *Boardman v. Phipps* [1976] 2 AC 46 (HLE).
\(^{51}\) Davis, *op.cit.* 42-44.
\(^{52}\) No third party values the contract at more than $4.
Illustration 3 assumes that the probability of litigation remains the same whether or not exemplary damages are available. In fact, the availability of exemplary damages may increase the probability of litigation because the windfall to P creates an additional incentive for P to sue. Polinsky and Shavell say that this effect, where applicable, should be taken into account in exemplary damages calculations.\textsuperscript{53} However, the adjustment in question makes no difference to the outcome, as Illustration 4 shows.

\textit{Illustration 4}. The facts are the same as in Illustration 3, except that the availability of exemplary damages increases $p$ to 1/3. On this basis, total damages are $9$: $3 \times 3$. D’s expected loss is $0.03 + 1/3($3 $\times 3)$: $3.03$, the same amount as in Illustration 3. Given D’s expected gain of $2.70$, it is still uneconomical for D to go ahead with the transaction even though P and D would jointly benefit if she did.

The problem Illustrations 3 and 4 demonstrate is that exemplary damages calculated as a multiple of D’s gain magnify the risk of Type 2 errors and are equivalent to an absolute prohibition of D’s transacting with P. As such, they negate the benefit of the rule allowing P and D to contract round the fiduciary standard. On the other hand, exemplary damages calculated as a multiple of P’s loss do not have this effect, as Illustration 5 shows.

\textit{Illustration 5}. The facts are the same as in Illustration 2. The court finds, rightly or wrongly, that if D had made proper disclosure, P would have valued the contract at

\textsuperscript{53} \textit{Op. cit.} 895.
$6, not $4. On this basis, P’s loss is $2. If exemplary damages are calculated as a multiple of P’s loss, total damages are $20: $2 x 10. D’s expected loss is $2.03: $0.03 + 1/10($2 x 10). D’s expected gain is $2.70, the same as in Illustration 2.

Taken account of ex ante, these figures give D the incentive to make proper disclosure, but even with proper disclosure it will still be economical for D to go ahead with the transaction. This outcome follows regardless of judicial error. By contrast, if the courts in a case like this were to calculate exemplary damages as a multiple of D’s gains instead, the risk of judicial error may make it uneconomical for D to go ahead with the transaction at all (as in Illustration 3). D cannot avoid the risk by making proper disclosure because, ex hypothesi, this is the very issue the court gets wrong.

To recapitulate, exemplary damages are not necessary in equity as a matter of course because equity has other ways of dealing with the under-deterrence problem in the context of fiduciary relationships and the like: the Keech v. Sandford reverse onus rule increases deterrence by raising $p$, while equity’s gains-based remedy system increases deterrence by raising $f$. An adverse judgment against a defaulting fiduciary carries a stigma and this, too, may increase $f$, particularly if it affects D’s business prospects. Nevertheless, there may be cases where equity’s special rules are insufficient for optimal deterrence. For example, $p$ may be atypically low because: (a) D took unusual steps to conceal the wrongdoing; or (b) the stakes are so low that P’s decision to litigate is against the odds. Exemplary damages might be calculated as a multiple of D’s gain or, alternatively, as a multiple of P’s loss (assuming P’s loss is quantifiable). Exemplary
damages calculated as a multiple of D’s gain are tantamount to a prohibition on the conduct in question and so they should be imposed only in cases where D’s conduct has social costs and no social benefits. For example, in Illustration 1, D in effect misappropriates the contract from P. Misappropriation by fiduciaries should be absolutely prohibited because it undermines the integrity of fiduciary relationships: P needs to be able to trust D because otherwise the value of the relationship to them both is diminished. Furthermore, an absolute prohibition on misappropriation encourages explicit trades: if D values the asset in question more highly than P does, it will be in P and D’s joint interests for P to sell the asset to D at a price between the values P and D respectively place on the asset. Illustration 6 demonstrates the deterrent effect of exemplary damages calculated as a multiple of D’s gain in a setting where an absolute prohibition of D’s conduct is warranted.

*Illustration 6.* Assume the same facts as in Illustration 1 except that now $p = 1/10$. If exemplary damages are calculated as a multiple of P’s loss, D’s expected loss is $4: 1/10(\$4 \times 10)$. Her expected gain is $6.30: \$7 \times (1-1/10). Consequently, D’s misconduct is still economical. If exemplary damages are calculated as a multiple of D’s gain, D’s expected loss is $7: 1/10(\$7 \times 10)$ and this makes D’s misconduct uneconomical.

In short, exemplary damages calculated as a multiple of D’s gain provide a stronger incentive against D’s misconduct than exemplary damages calculated as a multiple of P’s loss.
Exemplary damages may also be appropriate, regardless of \( p \), in cases where D obtained illicit pleasure from harming P, as in Illustration 7.

*Illustration 7.* Assume the same facts as in Illustration 1. D’s motivation for misappropriating the contract was to spite P. The spite factor is worth $10 to D. Given \( p =1 \), total damages should be at least $17: $7 + $10 in order to deter D.\(^{54}\)

In Illustration 6, exemplary damages should be the amount required to compensate for the low \( p \). In Illustration 7, exemplary damages should be the money equivalent of the illicit pleasure D obtained from harming P. Given that, in both cases, D’s conduct is a candidate for absolute prohibition over-deterrence is not an issue. Therefore, why limit exemplary damages in the manner just suggested: would it not be preferable to set exemplary damages as high as possible? This is a commonly asked question in the context of criminal sanctions. The standard response is that excessive penalties may give rise to marginal deterrence problems. Penalties should be proportional to the seriousness of the wrong to prevent offenders from gravitating to more serious wrongs: “the expected penalty for theft cannot be as high as for armed robbery, otherwise there will be incentives for wrongdoers to substitute the more serious for the less serious offense”.\(^{55}\)

\(^{54}\) *Ibid.* 909.

\(^{55}\) Chapman and Trebilcock, *op.cit.* 808-809. See also Law Commission, *op.cit.* para. 5.121, citing fairness to defendants as the justification.
4. Applications

(a) *Digital Pulse*

From a deterrence perspective, exemplary damages may be warranted if \( p \) is low because: (1) \( P \) was unlikely to discover the wrongdoing; or (2) \( P \)’s stakes in the litigation are low, so that it will probably be uneconomical for \( P \) to sue. In *Digital Pulse* itself it is doubtful whether these conditions applied. In relation to Condition (1), the trial judge found that D1 and D2 “clandestinely and systematically” diverted business opportunities from \( P \) to Juice until Juice was self-supporting.\(^{56}\) The inference is that D1 and D2 wanted to keep their actions secret only in the short-term and that once Juice became self-supporting they did not care if \( P \) found out. The judgment does not say how \( P \) actually found out, but it seems likely that \( P \) would have learned the truth in any event once the erosion of its client base came to light. In relation to Condition (2), \( P \)’s claim totaled close to $30,000 including interest but net of exemplary damages and the amount the trial judge awarded \( P \) was just over $13,000 again net of exemplary damages. These amounts, though not very large, are still substantial enough to make it probable *ex ante* that \( P \) would sue to recover them.

If \( p \) was high, why were D1 and D2 not deterred? The answer, as the trial judge’s finding suggests, is that their expected gains comprised not just the profits from the individual

\(^{56}\) *Digital Pulse Pty Ltd v Harris* (2002) 40 ACSR 427 at para. 121.
contracts they diverted from P, but also the business they were able to build up using the individual contracts as a springboard. These expected gains presumably exceeded the amounts D1 and D2 expected they would have to pay P and also any stigmatic effect an adverse judgment might have on them. Taking away D1 and D2’s business seems the most promising way of discouraging this kind of conduct in future. The primary remedy P asked for was an account of profits representing D1 and D2’s gains from the individual contracts. From a deterrence perspective, the shortcoming of this remedy has nothing to do with $p$. Rather, the problem is that the remedy fails to capture all D1 and D2’s gains from the wrongdoing. The remedy P should have asked for was a constructive trust over Juice’s assets or an account of profits for the equivalent sum.\(^ {57}\)

Exemplary damages may also be warranted, regardless of $p$, if D was motivated by spite. In *Digital Pulse*, while there was evidence that D1 and D2 derived pleasure from the success of their plan, there is no suggestion that they were activated by malice. Their pleasure seems to have been more in the nature of self-congratulation. Self-congratulation has an *ex post* aspect. *Ex ante*, it is unlikely that D1 and D2 would have factored it into their expected gains from the wrongdoing. Moreover if self-congratulation were a sufficient basis for exemplary damages awards, plaintiffs could be expected to ask for exemplary damages in nearly every case because it will be a rare defendant who fails to display some measure of self-congratulation on the apparent success of their wrongdoing. If courts had to calculate exemplary damages in nearly every case, litigation costs would increase without any obvious additional benefits.

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\(^ {57}\) Juice’s business appears to have been successful and so a constructive trust would have been a viable remedy: *Digital Pulse Pty Ltd v. Harris* (2002) 40 ACSR 487 at para. 140.
(b) *Aquaculture Corporation v. New Zealand Green Mussel Co. Ltd*

Contrast the New Zealand case of *Aquaculture Corporation v. New Zealand Green Mussel Co. Ltd*,\(^\text{58}\) which involved the misuse of confidential information. P had invested in tests and research on a mussel extract for use in the treatment of arthritis. P disclosed to D confidential information about the mussel extract which D wrongfully used in the manufacture of its own product. D ran a deliberately misleading advertising campaign in the United States which resulted in intervention by the Food and Drug Administration and caused widespread distrust in the remedy. The consequence was to spoil P’s own business prospects in the lucrative United States market. P sued D for breach of confidence, claiming compensation and also exemplary damages. The trial judge rejected P’s compensation claim on the ground that because breach of confidence is an equitable cause of action, damages are not available. However, he upheld the claim for exemplary damages. The Court of Appeal, overturning the trial judge, held that P was entitled to compensation. It also, by a majority, upheld the trial judge’s exemplary damages award. This seems a more promising case for exemplary damages. P’s claim was both novel and speculative and on the state of the then current authorities, it stood a low probability of success. The low probability of success may well have made it uneconomical for P to sue. D certainly thought so. There was evidence that D believed P could not afford to sue: “that the rewards to be gained by abusing [P’s] confidence were assured, while the risk of

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\(^{58}\) [1990] 3 NZLR 299 (CA).
being called to account was nebulous”59 Moreover, there was reason to believe that the stigma of an adverse judgment would not hit D particularly hard. D’s willingness to engage in a deliberately misleading advertising campaign suggests that its interest was in quick profits and that it did not particularly care about its reputation or longer-term standing in the market.

(c) Norberg v. Wynrib

Norberg v. Wynrib60 is another case where the court’s decision to award P exemplary damages seems appropriate. There P was addicted to painkilling drugs. D, a doctor, wrote her prescriptions in return for sexual favours. P sued D claiming general and punitive damages on the grounds of assault, negligence and breach of fiduciary duty. The trial judge dismissed her claim and the Court of Appeal upheld the trial judge. On further appeal, the Supreme Court of Canada held unanimously that P was entitled to relief. The majority (La Forest, Gonthier and Cory JJ) held that the tort of battery was the appropriate cause of action and they awarded P aggravated and punitive damages on this ground. McLachlin and L’Heureux-Dube JJ held that D was in breach of fiduciary obligation to P and they awarded her general and exemplary damages on that basis.61 P was probably low because P was under D’s influence as a result of her addiction and she was unlikely to make a complaint against him for as long as her addiction continued. Moreover, while the stigma of an adverse judgment would have destroyed D’s

59 Aquaculture Corporation v. New Zealand Green Mussel Co. Ltd (1986) 1 NZPR 678 at 691 per Prichard J.
61 It is not universally accepted that the doctor-patient relationship is for all purposes a fiduciary one: see, e.g., Breen v. Williams (1996) 186 CLR 71. However, the point does not matter for present purposes.
professional reputation, D was elderly and so he may have had little to fear, at least in economic terms, on that account. There is a possible alternative basis for an exemplary damages award. D gained illicit pleasure, in the form of sexual gratification, from the wrong he did P. On this basis, exemplary damages may have been warranted, regardless of $p$, as a way of capturing all D’s gains, so far as money allows.

(d) *Cook v. Evatt (No.2)*

In *Cook v. Evatt (No.2)*, the defendant investment advisors were in a fiduciary relationship with Cook (P) who was their client. The defendants breached their fiduciary obligations by on-selling to the plaintiff two home units in which they had an undisclosed financial interest. Fisher J. held the defendants liable to account to P for the secret profit they had made on the transaction. He also awarded P exemplary damages of $5,000 against the first defendant (D) on the ground that “he was using a façade of disinterested professional advice in order to covertly sell his own properties to vulnerable members of the public”. The purpose of the remedy, the judge said, was to “deter others who might be minded to exploit similar positions of trust”. Fisher J. raised, but did not systematically address, the question whether exemplary damages were necessary “having regard to the other remedies which will apply in any event” and the costs and adverse publicity of the trial. Nor did he explain how he arrived at the figure of $5,000, taking these various other factors into account.

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[63] Ibid. at 706-707.
[64] Ibid. at 707.
[65] Ibid. at 707.
A noteworthy feature of the case is that Fisher J., in calculating the defendants’ profits, made a generous allowance in their favour for the time, skill and effort they had put into locating the property, arranging for its purchase and various other functions. Such allowances are discretionary and it may seem inconsistent to make an allowance in D’s favour “while simultaneously mulcting him of punitive damages as a deterrent”. From a retributive perspective, it is true that the court cannot have it both ways: if D is blameless enough to deserve the allowance, it is hard to see how he also deserves to be punished. However, from a deterrence perspective there is no necessary inconsistency because for deterrence purposes the key variable is not D’s blameworthiness, but \( p \). For deterrence purposes, the approach should be to determine the amount \( P \) would have been entitled to if \( p \) had been 1 and then multiply that amount by the inverse of \( p \). The question of D’s entitlement to an allowance is relevant to the first step of the calculation, not the second.

In *Cook v. Evatt (No. 2)*, Fisher J appears to have assumed that \( p \) must have been less than 1 because breaches of fiduciary obligation are hard to detect. However, this is not a sufficient condition for an exemplary damages award in equity and, besides, it is not always true: *Digital Pulse* is probably a case in point. In *Cook v. Evatt (No.2)* itself, while it is true that D took steps to conceal his interest in the property at the point of sale to P, it must have been likely that P would find out sooner or later because D’s name appeared...
on the certificate of title. As it happened, P discovered the truth when she conducted a title search in preparation for selling the property some 18 months later.

(e) Attorney-General for Hong Kong v. Reid

In *Attorney-General for Hong Kong v. Reid*,71 the Government of Hong Kong (P) employed Reid (D) as a prosecutor. D accepted bribes in return for obstructing the prosecution of cases. P sued D for breach of fiduciary duty, claiming a constructive trust over the real estate. The Privy Council granted the remedy, justifying its decision on deterrence grounds and disapproving *Lister v. Stubbs*72 in the process. In *Lister v. Stubbs*, the court held that in bribe cases D should be required to account to P for the bribe money itself but not for any profits D may have made from investing the money.

In Lord Templeman’s words, “bribery is an evil practice which threatens the foundations of any civilized society”.73 Bribery is an example of conduct that has no social value and, as such, it is a clear candidate for outright prohibition. For effective deterrence, any remedy must capture all D’s gains. The *Lister v. Stubbs* remedy falls short in this respect because it captures only the bribe money itself and leaves D in possession of the second generation profits. By contrast, the constructive trust the court imposed in *Reid’s* case leaves D with nothing and it takes away any residual incentive to bribery in future

72 (1890) 45 ChD 1 (CA).
cases.\textsuperscript{74} However, this outcome is subject to $p$. If $p$ is low, D may still have an incentive to accept the bribe even though he knows that, if caught, he will not be allowed to keep any of the gains.

Bribery is difficult to detect. In Reid’s case, P presumably covered his tracks and so the risk of being caught ($p$) may not have been high. If disgorgement of profits was the only consequence D faced if caught, then an exemplary damages award may have been appropriate to round out the deterrence agenda. However, disgorgement of profits was not the only consequence: there were criminal consequences as well. As it happens, by the time of the civil action D had already been prosecuted and sentenced to 8 years imprisonment. Moreover, he had lost both his reputation and his means of livelihood. In short, while $p$ (the probability of being caught) may have been low, $f$ (the consequences of being caught) were high and so there was probably no need for an exemplary damages award. P did not ask for exemplary damages in Reid’s case, but if it had, the court may well have responded along these lines.\textsuperscript{75}

\begin{footnotesize}
\textsuperscript{74} Reid’s case has been criticized on the ground that, if D becomes bankrupt, the burden of the remedy will fall on D’s unsecured creditors and not D personally: see, e.g.: Roy Goode, “Proprietary Restitutionary Claims” in W. Cornish et al (eds), Essays in Honour of Gareth Jones (Hart Publishing Oxford, 1998), 63. From an ex post perspective, it may seem that the constructive trust remedy makes D’s other creditors worse off. However, from an ex ante perspective, the creditors are probably better off because the availability of the remedy increases the value of D’s services to P and presumably also the price P is prepared to pay for them.

\textsuperscript{75} Compare Daniels v. Thompson [1998] 3 NZLR 22 (CA) and Gray v. Motor Accident Commission (1998) 196 CLR 1 (HCA) (a prior criminal conviction bars an exemplary damages award) and Whiten v. Pilot Insurance Co. (2002) 209 DLR (4th) 257 (SCC) (criminal sanctions are relevant, but not a bar to, a punitive damages award). On the relationship between exemplary damages and criminal sanctions, see further text at nn 103-113, below.
\end{footnotesize}
5. Other issues

(a) Retribution and deterrence

*Digital Pulse* raises a question about the relationship between the retribution and deterrence functions of exemplary damages awards. The trial judge suggested that the functions are cumulative: exemplary damages serve “to punish the wrongdoer for reprehensible conduct; to deter not only the wrongdoer but others of like mind in the community from similar conduct; [and] to ameliorate the victim’s sense of grievance”.76 In the Court of Appeal, Mason P., dissenting, endorsed the trial judge’s position. “I am unaware,” he said “of any authority that suggests that it is possible or desirable to segregate these functions”.77 Mason P.’s statement was in response to the defendants’ argument that: (1) the function of exemplary damages is retribution, not deterrence; (2) equity deters but it does not punish; (3) therefore exemplary damages cannot be awarded in equity. The foregoing discussion casts doubt on the correctness of Proposition (1). The following discussion endorses the implication of Proposition (2), that “the notion of deterrence and the notion of punishment [retribution] are quite distinct”.78

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76 Quoted in *Digital Pulse* (2003) 56 NSWLR 298 at para. 242 per Heydon JA.
78 (2003) 56 NSWLR 298 at para. 264 per Heydon JA quoting counsel’s argument from the transcript.
Deterrence is the effect that the prospect of having to pay damages will have on the behaviour of similarly situated parties in future cases.\textsuperscript{79} Retribution is the imposing of appropriate sanctions on blameworthy parties.\textsuperscript{80} Deterrence is forward-looking and consequentialist, whereas retribution is backward looking and desert-based.\textsuperscript{81} Chapman and Trebilcock have demonstrated that retribution and deterrence are incompatible functions in the sense that measures the law adopts in support of one function will necessarily be inconsistent with the measures that would be needed in support of the other function. For example: (1) the grossing up of damages the deterrence theorist favours is anathema to the retributivist: “for the retributivist, the promotion of any good extrinsic to punishment as desert, even the promotion of deterrence, is unjust in that it treats [the] individual who is caught and obliged to pay the penalty as a mere means for the good of others”.\textsuperscript{82} (2) From the retributivist’s perspective, there should be no vicarious liability for exemplary damages: “it is of the essence of traditional theories of retribution that individual wrongdoers are deserving of punishment but that, conversely, individuals who are innocent of wrongdoing are not. Vicarious liability by definition violates these precepts”.\textsuperscript{83} On the other hand, from a deterrence perspective, vicarious liability for exemplary damages makes sense: “vicarious liability creates efficient incentives for loss-avoidance precautions by principals and agents [particularly] where there is a risk of agent insolvency, where the agent’s loss avoidance behaviour is cheaply observable by the employer, or where multiperiod agency relationships make available a

\textsuperscript{79} Polinsky and Shavell, \textit{op.cit.} 877.
\textsuperscript{80} \textit{Ibid.} at 948.
\textsuperscript{81} Chapman and Trebilcock, \textit{op.cit.} 780.
\textsuperscript{82} \textit{Ibid.} 798.
\textsuperscript{83} \textit{Ibid.} 779.
more extensive set of incentive devices to the principal”. 84 (3) From a retributivist’s perspective, punitive damages should not be insurable because insurance reduces the punishment of the wrongdoer. 85 On the other hand, from a deterrence perspective the insurability of exemplary damages is justifiable on the same basis that insurability of compensatory damages is justifiable, namely that it reflects a trade-off between risk allocation and incentives. 86 Moreover, insurers with access to efficient information on the conduct of many insureds may be good ex ante monitors of the possibility of conduct leading to liability. 87 (4) From the retributivist’s perspective, punitive damages represent a form of contracting out or delegation of the state’s enforcement function to private individuals acting on its behalf. 88 Therefore, “all the procedural protections that apply to public enforcement actions designed to serve retributive ends should apply, in principle, to private enforcement actions activated by the same rationale”. 89 Specifically: (a) potential violators should be given adequate prior notice of what forms of conduct will attract punishment; (b) the standard of proof should be the criminal, not the civil, standard; (c) the determination of the sanction should be the function of the trial judge, not the jury, to ensure consistency in level of punishment from one case to the next; and (d) double jeopardy must be avoided to prevent excessive punishment. Double jeopardy issues may arise if D is subjected to civil litigation followed by a criminal prosecution for the same conduct (or vice versa) or if D is subjected to multiple civil suits each claiming

85 Chapman and Trebilcock, op.cit. 821-822.
86 Ibid. 801.
87 Ibid. 823. See also Polinsky and Shavell, op.cit. 931-934. In England, the Law Commission has recommended that exemplary damages should be insurable: op.cit. paras 5.234-5.273.
88 Chapman and Trebilcock, op.cit. 804.
89 Ibid.
punitive damages.90 On the other hand, from a deterrence perspective exemplary damages are simply an extension of compensatory damages and so special procedural protections are no more required than they are in civil litigation at large.91 Moreover, while special procedural protections such as the criminal standard of proof reduce the risk of Type 2 errors (unjustified findings of guilt), they increase the risk of Type 1 errors (unjustified findings of innocence). “Within a retributive rationale [Type 2 errors] are to be avoided, even at the expense of [Type 1 errors].”92 On the other hand, from a deterrence perspective, there is no basis for preferring one type of error to another: “each type of error is equally to be avoided, if feasible”.93

In Digital Pulse, the trial judge’s reasons for awarding P exemplary damages were a mix of mainly retribution and deterrence factors.94 However, retribution seems to have been the overriding concern. Chapman and Trebilcock’s analysis suggests that: (1) the reason should have been either retribution or deterrence but not both; and (2) if the reason was retribution, the court should not have awarded P exemplary damages without affording D the same procedural safeguards the criminal law allows. On the other hand, if the reason was deterrence, it is open to question whether exemplary damages were necessary at all.95 In the Court of Appeal, Heydon JA questioned the availability of exemplary damages in the absence of the procedural safeguards the criminal law

90 Ibid.
91 Ibid. However, rules against double jeopardy may be necessary to prevent over-deterrence: ibid. 826. See also Polinsky and Shavell, op.cit. 926-928.
92 Chapman and Trebilcock, op.cit. 804.
93 Ibid. 826.
94 See text at n.15, above. Compensation was also a factor: see text at n.29-31, above.
95 See text at nn 56-57, above.
allows. However, as Chapman and Trebilcock’s analysis indicates, these observations are relevant if the function of exemplary damages is retribution, but not necessarily if the function is deterrence.

(b) Equity does not punish

The proposition that equity does not punish was explained by James LJ in *Vyse v. Foster.*

“this Court has no jurisdiction in this class of case to punish an executor for misconduct by making him account for more than that which he actually received, or which it presumes he did receive, or ought to have received. This Court is not a Court of penal jurisdiction. It compels restitution of property unconscientiously withheld; it gives compensation for any loss or damage through failure of some equitable duty; but it has no power of punishing anyone …A trustee, for instance, directly lending money to his firm is answerable for such money with full interest to the uttermost farthing; but to make him answerable for all the profits made of such money by all the firm would be simply a punishment – a punishment arbitrary and most unreasonable in this, that its severity would be in the inverse ratio of the gravity of the offence. A man squandering trust money with deliberate dishonesty in profligate extravagance would be answerable for it with 4 per cent interest; a man lending it (at good interest) to a large, solvent, and prudent, well-established firm, of which he was a partner, would be punished by a fine equal to all the profits made thereby by all his partners”.

In *Digital Pulse,* Heydon JA quoted this passage as a statement “pointing distinctly against the availability of exemplary damages in equity”. However, the references in the

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97 See also Beever, *op.cit. (1) “the alleged point of [exemplary damages] is to punish and deter. This cannot be achieved efficiently if the defendant has insurance” (at 95); (2) “If exemplary damages serve to punish the wrongdoer, then it seems both senseless and unjust to hold his innocent employer liable” (at 96); and (3) “it is inappropriate when deciding on punishment to adopt the private law’s rules of evidence or the civil standard of proof” (at 110). Again, these statements presuppose that the function of exemplary damages is retribution.
98 (1872) LR 8 ChApp 309 at 333-334.
statement to “punishment” can be read as meaning retribution alone and not deterrence as well. In fact the references probably have to be read that way because otherwise it is hard to reconcile the statement with equity’s prophylactic function, which was acknowledged in Digital Pulse.\textsuperscript{100} In any event, the statement is more an argument against over-deterrence than against deterrence as such. From a deterrence perspective, the first example James LJ gives may well be a case for taking away all D’s profits, but the second clearly is not.\textsuperscript{101} Taking away all D’s profits amounts to an absolute prohibition on the conduct in question. In the first example, D’s conduct has no social utility and there is nothing to be gained by permitting it in any circumstances. However, in the second example, D’s conduct may benefit both P and D and an absolute prohibition would not be in either party’s interests.\textsuperscript{102}

(c) Exemplary damages and criminal sanctions

In cases where an exemplary damages award may be appropriate, there is a fair chance that D’s conduct will also be a criminal offence.\textsuperscript{103} Deterrence is one function of the criminal law. If D’s conduct is subject to criminal sanctions, from a deterrence perspective what more is to be gained by awarding exemplary damages against him as well? The answer turns on the relative merits of public and private law enforcement.\textsuperscript{104}

\textsuperscript{100} (2003) 56 NSWLR 298 at paras 404-420 \textit{per} Heydon JA.
\textsuperscript{101} The two examples are distinguishable from the retributivist’s perspective as well: in the first example, D’s conduct is more morally reprehensible than it is in the second example.
\textsuperscript{102} See text at 48-53, above.
\textsuperscript{103} \textit{Digital Pulse} (2003) 56 NSWLR 298 at para 352 \textit{per} Heydon JA.
The main arguments in support of private law enforcement are as follows.105 (1) Public law enforcement authorities lack the resources to investigate and prosecute all offences and private law enforcement may help fill the gap. (2) Private law enforcement may save administrative and litigation costs by allowing punishment (deterrence) and compensation issues to be determined in the same trial. (3) Private law enforcement may be more efficient than public law enforcement at the margins because the private plaintiff has an immediate stake in the outcome of the litigation and a stronger motivation to see the case through to a successful conclusion. (4) In the case of public law enforcement, D pays a much larger penalty than the amount the public law enforcer receives as salary, whereas in the case of private law enforcement the private law enforcer captures the full amount of the penalty. The higher returns to the private law enforcer may reduce the incentives for bribery and corruption. (5) Private law enforcement allows the penalty to be determined ex post by reference to the particular facts of the case, having regard to the probability that D would escape liability. By contrast, criminal sanctions are determined ex ante, in part presumably, on the basis of information about the number of likely successful prosecutions on average across the number of violations at large.106

The main arguments against private law enforcement are that: (1) it may result in over-deterrence if numerous private law enforcers are attracted to high returns; (2) private enforcement may be employed for strategic and private reasons that conflict with the public goals of the law being enforced; and (3) private enforcement can disrupt decisions

105 Ibid. See also Chapman and Trebilcock, op.cit. 786-797.

not to prosecute that may be based on a coherent and defensible policy arrived at by public officials.\(^{107}\) Roach and Trebilcock argue that most of these weaknesses can be addressed by procedural safeguards and rules against double jeopardy and they note, in particular, that the “loser pays” rule together with restrictions on damages awards, civil jury trials, class actions and contingency fees may prevent some of the excesses of the American experience with private enforcement.\(^{108}\) The lesson they draw from the debate is that private and public enforcement perform complementary functions: “private enforcement will be of most value in those cases in which the rewards available are greater than their enforcement costs”, while “public enforcement is most needed in those cases where the fine or damages that can be extracted from a wrongdoer is significantly less than the costs of enforcement”.\(^{109}\)

Polinsky and Shavell argue that exemplary damages should be reduced to reflect any public penalties D has paid for the same conduct.\(^{110}\) By implication, the reverse also holds: public penalties should be reduced to reflect exemplary damages awarded against D in earlier civil proceedings. “The defendant’s total payment,” they say, “should be such that his expected payment equals the harm done. If punitive damages are not reduced from the amount implied by our formula to reflect public penalties borne by the defendant, the defendant’s combined public and private payments would result in his expected damages payments exceeding the harm done”.\(^{111}\) Their concern is to prevent

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\(^{107}\) Roach and Trebilcock, *op.cit.* 484-489.


\(^{111}\) *Ibid.* 927. See also Law Commission, *op.cit.* paras 5.103-5.115. The same limitation applies in the case of related private litigation. Exemplary damages the court awards P1 should be taken into account by a later court when considering exemplary damages for P2: *ibid.* 923-926. Polinsky and Shavell suggest the
over-deterrence. Over-deterrence is not a concern in cases like Illustrations 6 and 7, above. Nevertheless, there is still a case for saying that the total penalty imposed on D should not exceed the amount needed for optimal deterrence. For one thing, excessive penalties may cause marginal deterrence problems.¹¹² For another thing, penalties may run counter to community sentiments if they are both unnecessary for deterrence purposes and out of proportion to the degree of D’s moral blameworthiness and they may bring the law into disrepute on that account.¹¹³

(d) Exemplary damages and contract

In Australia, exemplary damages cannot be awarded for breach of contract.¹¹⁴ The same is true in England,¹¹⁵ but not all common law jurisdictions have followed suit.¹¹⁶ In Digital Pulse, D1 and D2’s wrongdoing was a breach of their contracts of employment with P as well as being a breach of fiduciary duty. Spigelman CJ’s main reason for denying P’s exemplary damages claim was that exemplary damages cannot be awarded for a breach of fiduciary duty that is also a breach of contract because it would be anomalous if a plaintiff could recover exemplary damages by suing the defendant on one

¹¹² See text at n.55, above.
¹¹³ See text at n.41, above.
¹¹⁴ Butler v. Fairclough (1917) 23 CLR 78; Whitfield v. de Lauret & Co. Ltd (1920) 29 CLR 71; Gray v. Motor Accident Compensation Commission 1.
ground rather than the other.\textsuperscript{117} This raises the question whether a blanket rule disallowing exemplary damages for breach of contract is warranted.

Polinsky and Shavell say that in most cases, the parties will not want damages for breach of contract to exceed the compensatory level because “the breach is obvious, the nature of the breach is such that it easily can be proven in court, and the amount at stake is large enough to justify suit”.\textsuperscript{118} Nevertheless, parties may want exemplary damages in two contexts where D might escape liability: (1) when there is a chance that P will not discover the breach;\textsuperscript{119} and (2) when P knows about the breach but cannot prove it or lacks a financial incentive to sue.\textsuperscript{120} In both cases, “there is a probability that [D] will not be found liable if he does harm [by breaching the contract]”.\textsuperscript{121} The role of the exemplary damages award is the same in contract as it is in other contexts, namely to make up for

\textsuperscript{117} (2003) 56 NSWLR 298 at paras 28–44. See also paras 294–295 \textit{per} Heydon JA.

\textsuperscript{118} \textit{Op.cit.} 938. High litigation costs alone are not a sufficient reason for exemplary damages. Procedural measures to reduce litigation costs (\textit{e.g.}, provision for mediation or arbitration) are an alternative solution. Cost-cutting measures facilitate deterrence by raising $p$, whereas exemplary damage awards increase $f$. Increasing $p$ is probably a better option, given the costs of calculating exemplary damages: see Alan Schwartz, “The Myth That Promisees Prefer Super-Compensatory Remedies: An Analysis of Contracting for Damage Measures” (1990) 100 \textit{Yale Law Journal} 369 at 395–405. Procedural solutions do not address the cases Polinsky and Shavell identify. Exemplary damages should not be awarded for breach of contract simply to validate P’s interest in realizing gains from trade: \textit{ibid.} at 369–372 and 405–407.

\textsuperscript{119} They give the following example: “consider a company that contracts with a city to replace its burned-out streetlights. Suppose that the company would have to pay punitive damages of $200, in addition to compensatory damages of $50, if the city discovers that a light was not replaced in a timely manner (say, one week after burning out). The reason we can imagine the parties would want punitive damages in this situation is that they both recognize that the city will not discover most of the lights that burn out and that are not repaired on a timely basis. They realize that setting total damages for breach in excess of the loss from breach will give the repair company a stronger and more appropriate motive to search for and replace burned-out streetlights than would compensatory damages alone”: \textit{op.cit.} 937.

\textsuperscript{120} “For instance, if an insurance company fabricates a reason for not paying a small claim, the insured may not sue because of the uncertainty of success and the cost of a lawsuit. But because insureds would in principle be willing to pay higher premiums if an insurance company can be deterred from acting in this way, the insurer may benefit from an agreement to pay punitive damages when it is found liable for falsely denying a small claim”: \textit{ibid.} 938.

\textsuperscript{121} \textit{Ibid.}
the chance that D may escape liability.\textsuperscript{122} In summary, from a deterrence perspective there is no basis for treating breach of contract differently from other wrongs and the wisdom of a rule disallowing exemplary damages for breach of contract in any circumstances seems questionable.\textsuperscript{123}

6. Conclusion

From a law and economics perspective, the function of exemplary damages is deterrence. More specifically, the function is to achieve optimal deterrence in cases where the probability of a successful suit against the defendant is less than 1. Total damages should equal the amount of the plaintiff’s loss or the defendant’s gain, as the case requires, multiplied by the inverse of the probability that the plaintiff will successfully sue the defendant. On this basis, exemplary damages are the excess of total damages over the plaintiff’s primary claim. There is no need for exemplary damages in equity as a matter of course. Equity has other measures to address the under-deterrence problem, in particular: (1) the \textit{Keech v. Sandford} reverse onus rule which increases deterrence by raising $p$; and (2) a gains-based scheme of remedies which increases deterrence by raising $f$. Furthermore, if the courts award exemplary damages too readily, they may create an over-deterrence problem. Exemplary damages calculated as a multiple of P’s loss may be warranted if $p$ is atypically low, for example because: (1) D took unusual

\textsuperscript{122} \textit{Ibid.}

\textsuperscript{123} Contrast Law Commission, \textit{op.cit.} paras 5.71-5.73, recommending that exemplary damages should not be available for breach of contract. “A state-supplied right to sue for punitive damages is similar to a contract-supplied right to sue for a penalty”: Schwartz, \textit{op.cit.} 370. Therefore, relaxation of the rule against exemplary damages in contract may require reassessment of the penalties doctrine. It is inconsistent to allow the state-supplied remedy but to disallow the contract-supplied alternative: see Polinsky and Shavell, \textit{op.cit.}937n.
steps to conceal the wrongdoing; or (2) low stakes mean that it would normally have been uneconomical for P to sue. Exemplary damages calculated as a multiple of D’s gain should only be imposed where an absolute prohibition of D’s conduct is required because the conduct has social costs and no social benefits. In such cases, an exemplary damages award might be appropriate if: (1) \( p \) is atypically low; or (2) regardless of \( p \), D has derived illicit pleasure from the wrongdoing. Exemplary damages were probably not warranted in *Digital Pulse* itself because \( p \) seems to have been high. From a deterrence perspective, a constructive trust over Juice’s assets or an account of profits for the equivalent sum might have been a more appropriate remedy.

The trial judge’s decision in *Digital Pulse* to award P exemplary damages was based on a mix of mostly retribution and deterrence considerations. His judgment, in common with the earlier judicial pronouncements he relied on, suggests that retribution and deterrence are cumulative functions. However, the two functions are incompatible in various respects. Most importantly, the deterrence function requires that damages should be grossed up to counteract any reduced probability that P will discover D’s wrongdoing and successfully sue D for it whereas the retribution function requires that damages should be strictly proportional to the degree of D’s blameworthiness. The courts cannot pursue both functions simultaneously without compromising one or the other.

The question whether exemplary damages should be available in equity is a deceptively simple one. On closer examination, it turns out to implicate a range of quite difficult decisions concerning the function, scope and calculation of the remedy and the
relationship between the remedy and other branches of the law, including criminal law and the law of contract. Having regard to these difficulties, the majority’s deference in *Digital Pulse* to the High Court and the legislature makes sense.