Establishing a Good-Faith Defense to Punitive-Damage Claims

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THE RAND INSTITUTE FOR CIVIL JUSTICE

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The U.S. civil justice system is widely regarded as the most expensive among developed countries. Lawyers who represent multinational companies readily attest to the fact that the U.S. legal system imposes costs on its clients that are orders of magnitude higher than those borne elsewhere. Two highly visible features of this civil justice system may well be unique in terms of their impact on personal injury claims, settlements, and verdicts:

1. The ability of plaintiffs to recover against a defendant for harms allegedly caused by a defect in a product’s design, manufacture, or marketing regardless of whether the defendant exercised great care, and

2. The ability of civil juries to go far beyond simply compensating plaintiffs for their losses by granting awards designed solely to punish defendants.

Regardless of product liability practice in other countries, there is a perception in the business community that American courts adjudicate such claims and grant such awards more often than anywhere else in the world. Consequently, corporate lawyers and their clients place product liability and punitive damages law high on their agendas for reform. Furthermore, this raised level of concern can be found in many industrial sectors despite significant differences in liability risks.

Why do so many believe so strongly in the need to reform these laws? And why do they hold this view despite the facts that punitive damages are rarely imposed in product liability trials and the occasional blockbuster jury award is invariably reduced by the trial judge or on appeal? Opponents of reform argue that these facts should mitigate business’s qualms, but they do not. Punitive damages in product liability cases continue to be an issue of grave concern because the standards for imposing liability remain ill defined, leav-
Because the standards for imposing liability in product cases remain ill defined, firms feel exposed to risk and frustrated in efforts to protect themselves from punitive damages.

The most frightening consequence of an unfavorable product liability verdict—runaway punitive-damage award—can indeed be severe. Because a punitive award may often have no relationship to the extent of the injuries suffered by a plaintiff, the financial exposure may be unlimited when liability is imposed. Stories of excessive awards reverberate in the business community. For example, a July 1999 decision in a Los Angeles state court awarded $4.8 billion in punitive damages to six people injured by fire when a drunk driver crashed into their 1979 Chevrolet Malibu and caused the fuel tank to rupture. Even though the award was later reduced to $1.2 billion by the trial judge, to many observers the story illustrates the business community’s central concern in the current debate: Punitive damages are often imposed in circumstances where they do not appear to have been warranted, and even when some award of punitive damages would be appropriate, they are imposed in wildly excessive amounts. In response, defenders of the current system claim that punitive damages serve a valid purpose both in punishing a defendant for inappropriate acts and in deterring future wrongful conduct by the defendant and others.

PUNITIVE-DAMAGE AWARDS SHOULD FOSTER GOOD BEHAVIOR

Punitive damages are justified on the grounds that they punish blameworthy conduct. However, when the defendant is a firm rather than an individual, serious questions arise as to whether this objective can be achieved, particularly if the primary goal is to punish the particular individuals within the firm responsible for the misconduct. The current system is apt to visit particularly harsh results when a firm selling a generally safe product or providing a generally legitimate service is exposed to punitive damages as the result of bad conduct by a single person or small group of employees who have acted contrary to firm policy. Even the most safety-conscious policies and procedures paired with their good-faith implementation cannot prevent such occurrences.

As long as firms believe, rightly or wrongly, that juries impose punitive damages under standards that are arbitrary, uncertain, and unpredictable, the threat of them is unlikely to deter inappropriate behavior. On the other hand, if firms could take clear steps that would reduce the threat of punitive damages and if the failure to take such steps could be shown to have real liability consequences, the threat of punitive damages would have a greater likelihood of actually deterring unwanted behavior.¹

NO CLEAR WINNER IN THE LEGISLATIVE WAR

Over the last twenty years, a costly political battle over tort reform and punitive damages has been fought in Congress and state legislatures—with the business community on one side and consumer groups and trial lawyers on the other. Neither continuing research nor a vigorous policy debate has been successful in resolving the matter. In recent years, the battle has even spread to include fights for control of state supreme courts because the fate of state-level reforms will ultimately be decided there.

In general, the business community has sought to cap punitive-damage awards in order to mitigate the possibility of extreme and irrational jury verdicts. Business thinks these caps should be based on a multiple of the compensatory damage awards handed down by juries (such as twice or three times the compensatory award), an absolute monetary ceiling, or an amount tied to the defendant’s assets or income (e.g., the greater of $50,000 or 10 percent of a business’s net worth). However, the business community’s effort to secure reform at the federal level has failed thus far, and some successful state-level reform efforts have been overturned by state high courts on state constitutional grounds. With the reform movement stalled in the legislative arena, firms will continue to face an uncertain legal environment, a situation made even more complex by the fact that legal standards for the conduct required to impose punitive damages differ significantly from state to state. Whatever the viability of a “caps” approach to limiting punitive damages, their imposition clearly requires legislation. At this stage in the debate, a lasting legislative remedy may not be possible.

The position of consumer groups and trial lawyers has generally been to oppose caps. These groups believe that existing consumer protection laws and product safety guidelines are weak and toothless and that only the threat of a massive punitive-damage award can guarantee that corporations will behave responsibly. Public Citizen, for example, has asserted that “[p]unitive damage caps completely undermine the central and historic purpose of punitive damages: imposition of an amount of damages sufficient to deter and punish reckless and egregious misconduct.”

Whether or not there is merit to this claim, the intensity of the opposition at the legislative level to a cap-based approach (and the possibility that any such legislation would be subsequently overturned by an appellate court) suggests that those who seek true reform might be better advised to use a different path, one that avoids constitutional pitfalls while at the same time addressing the concerns of those who see the legal system as a way to ensure safer products.

“With the reform movement stalled in the legislative arena, firms continue to face an uncertain legal environment.”


THE STANDARD FOR IMPOSING PUNITIVE DAMAGES MIGHT BE IMPROVED WITHOUT RESORT TO LEGISLATION

Since the rules for assessing punitive damages derive from judicially created standards in the first place, an alternative to a legislative remedy might be found if the common law of punitive damages could be developed so that the circumstances in which they were applicable were made more certain and more equitable. For instance, when punitive damages are imposed against an organization rather than a specific individual, juries could award them according to the level of corporate involvement—stinging firms whose official actions and policies endanger the public but sparing those that have been exposed to punitive damages because an isolated party acted contrary to firm policy. Businesses would then be motivated to implement good safety standards while at the same time they would have a way to protect themselves.

This approach to checking the excesses of some punitive-damage awards follows the logic of a recent Supreme Court decision. In *BMW of North America, Inc. v. Gore*, the Supreme Court offered several yardsticks to impose constraints on a jury’s discretion in setting the size of punitive-damage awards for the purpose of ensuring that they are reasonable and rational. The Court said that awards must take into account the defendant’s degree of reprehensibility and must bear a reasonable relationship to compensatory damages. Awards must also take into account and accord “substantial deference” to the legislature’s intention concerning appropriate sanctions for the conduct at issue, and they may not punish conduct outside the jurisdiction. These guidelines, although rough and general, appear to be influencing other appellate courts; they give reason for hope that recent efforts to refine the standards for imposing punitive damage liability might also improve outcomes. A policy where punitive damages would be assessed against corporations only when the firm’s behavior—rather than that of low-level employees—was at issue would clearly follow the spirit of the Supreme Court’s obvious concern with ensuring that punitive-damage awards are both reasonable and rational.

CURRENT STANDARDS DO NOT ADEQUATELY DISTINGUISH BETWEEN FIRM AND INDIVIDUAL BEHAVIOR

A variety of formulations have been used and suggested as legal tests for the imposition of punitive damages. Some have focused on the defendant’s state of mind and others on the nature of the conduct. A traditional standard has been to require that the defendant acted with “malice”
or with a "willful, wanton and reckless disregard" for the rights of others. But it is a bit far-fetched to conceive of a corporation as acting with "malice"; that notion exists as a legal fiction. In an effort to make the standard more relevant to corporate behavior, tort law expert David Owen has suggested a standard based on "flagrant indifference to public safety."6 The Restatement (Second) of Torts provides for the award of punitive damages for "conduct that is outrageous, because of the defendant's evil motive or his reckless indifference to the rights of others."7 This language, however, is inadequate; it does not explicitly require the conduct to be deliberate or to represent a "gross deviation" from the appropriate standard of care.8 Whatever specific language is used, the standard should require a showing of conduct that meets both of these requirements. Unfortunately, the recently published revision of Restatement (Third) of Torts, Section 402, does not specifically address punitive damages in product liability cases.9

Notwithstanding the inadequacy of the current standard, if the question is limited to the specific conduct of the individual employees that led to the plaintiff's injury, and not focused on the overall conduct of the enterprise, liability may be imposed even though the jury would agree that management had taken the right steps to provide a reasonably safe product or service. For example, in the case of a complex consumer product that reflects the input of many, perhaps hundreds of people making thousands of individual judgments, one reckless decision totally inconsistent with all the others and contrary to the firm's well-designed policies and procedures may expose the organization to punitive damages. This unfair result follows from the application of general agency principles. Though these principles are clearly sound for the purpose of establishing liability for compensatory damages, they are not appropriate for awarding punitive damages. When applied in the context of punitive damages, the general agency principle does not provide the right incentives; indeed, it may be counterproductive to deterring wrongful conduct. For example, a corporation may be reluctant to establish internal guidelines for ensuring the safe design, manufacture, or marketing of a product if it believes that the violation of these formal policies by a "rogue" employee might make it a good candidate for a punitive-damage verdict.

Whatever standard is used for the imposition of punitive damages, whether it require proof of bad motive, or actual malice, or merely "conscious indifference," the plaintiff should be required to impute this conduct to the enterprise. It has long been recognized under common law that agency principles

7Restatement (Second) of Torts § 908 (1977).
limit vicarious liability for punitive damages. Identical provisions are found in the Restatements of Agency and Torts:

Punitive damages can properly be awarded against a master or other principal because of an act by an agent if, but only if:

(a) the principal authorized the doing and the manner of the act, or

(b) the agent was unfit and the principal was reckless in employing him, or

(c) the agent was employed in a managerial capacity and was acting in the scope of employment, or

(d) the principal or a managerial agent of the principal ratified or approved the act.\textsuperscript{10}

However, even where the rule of the jurisdiction limits vicarious liability for punitive damages to acts of “managerial” agents, low-level employees with limited discretion, such as the “night manager” of a motel or an insurance claims adjuster, have frequently been held to have been acting in a managerial capacity.\textsuperscript{11}

While the majority of jurisdictions follow some form of the Restatement rule, a minority follows a more liberal approach that imposes vicarious liability upon the principal so long as the agent was acting within the scope of employment, whether or not in a managerial capacity.\textsuperscript{12} In those jurisdictions that follow the more liberal rule, corporations have been held liable for punitive damages as the result of actions taken by clearly “menial” agents.\textsuperscript{13}

\textbf{SAFETY COMPLIANCE PROGRAMS SHOULD PROVIDE AN AFFIRMATIVE DEFENSE}

The Supreme Court recently reviewed agency principles in the context of an employment discrimination suit, \textit{Kolstad v. American Dental Ass'n},\textsuperscript{14} brought under the Civil Rights Act of 1991. The 1991 act makes punitive damages available in claims under Title VII of the Civil Rights Act of 1964 but limits them to cases of “intentional” discrimination. The act sets forth the standard in language that is very consistent with the common law standard—allowing punitive damages where the defendant has engaged in discrimination “with malice or with reckless indifference to the federally protected rights of an aggrieved individual.”\textsuperscript{15} In its opinion on \textit{Kolstad}, the Supreme Court noted that even intentional torts are within the scope of an agent's employment if the conduct is the kind the employee has been employed to perform, occurred substantially within “authorized time and space limits,” and was actuat-
ed at least in part to serve the employer's interests.\textsuperscript{16} If these tests are met, the court further noted that even acts specifically forbidden by the employer or acts using specifically forbidden means may be said to fall within the scope of employment and therefore impose vicarious liability on the employer.\textsuperscript{17}

In Kolstad the court found that applying the standard agency rules on "scope of employment" in the Title VII punitive-damage context would reduce the incentive for employers to implement compliance programs. Indeed, the court suggested that such a rule might penalize employers who educate their employees on Title VII compliance by creating an inference that any violation by such "educated" employees must have been intentional. The court went on to hold that "an employer may not be vicariously liable for the discriminatory employment decisions of managerial agents where these decisions are contrary to the employer's 'good-faith efforts to comply with Title VII.'"\textsuperscript{18} The policy considerations that underlie this decision appear to be applicable to many other punitive-damage contexts, including product liability.

The Kolstad decision appears to mark a change in the Court's view of how to create incentives for corporate compliance programs. Almost a decade earlier, the Supreme Court in Pacific Mutual Life Insurance Co. v. Haslip affirmed a punitive-damage award against a corporation, arguing that it was being punished for the unauthorized conduct of an agent acting for his own benefit.\textsuperscript{19} At that time, the Court refused to find that Alabama's rule holding a corporation liable for punitive damages for fraud committed within the scope of employment did not advance the state's interest in minimizing fraud. The Court found that imposing liability would provide an incentive to guard against fraud and worried that if a corporation could be held liable only upon a showing of "independent fault," it would have an incentive to minimize oversight of its agents. In Kolstad, the Court now turns the focus of attention to the firm's conduct and offers protection to employers who make good-faith efforts to prevent discrimination in the workplace. Following this reasoning, it could be argued that the corporation in Haslip should have been protected, not merely by the absence of "independent fault," but if it could have shown that it had made a good-faith effort to prevent fraudulent conduct by its agents.

\textbf{A GOOD-FAITH DEFENSE WOULD CREATE SAFETY INCENTIVES FOR BUSINESSES}\textsuperscript{20}

In product liability and other substantive areas of tort law, the public policy objectives of punitive damages might be better achieved if the threat of them provided firms with clearer incentives to act for the overall good of their customers and the public. The policy suggested here would encourage management to act in ways available to it to improve safety. For example,

\textit{"In Kolstad, the Supreme Court turned the focus of attention to a firm's conduct and offered protection to ones that made good-faith efforts."}

\textsuperscript{16}ibid, 119 S.Ct. at 2128.

\textsuperscript{17}Recognizing this problem, the American Law Institute Reporters' Study Enterprise Responsibility for Personal Injury took the position that in the case of claims for punitive damages in product liability cases, a firm should be liable only for the conduct of its "higher-level" officials. No effort was made to define this term. Volume II, Approaches to Legal and Institutional Change, p. 251, 1991.

\textsuperscript{18}Kolstad v. American Dental As'n, 119 S.Ct. at 2129.


\textsuperscript{20}Although the policy arguments made here in the punitive-damage context might be extended to include criminal charges against corporations, the protections available under existing law and practice mitigate the need to press for change. In contrast with claims for punitive damages, in criminal cases the maximum penalty is defined, the sentence is imposed by a judge rather than a jury, and, theoretically at least, the public interest rather than private gain is guiding the prosecutor. Moreover, firms have the opportunity to qualify for reduced penalties under the Sentencing Guidelines by implementing compliance programs.
while it cannot make the engineering decisions that go into every element of a product's design, a firm's management could adopt procedures requiring careful analysis of all parts of a product having safety implications, call upon engineers to achieve safety levels beyond regulatory requirements, insist on detailed safety standards, train employees to meet standards, and audit employees' compliance. The better designed these procedures and processes, the more convincing they would be in demonstrating a company's good faith and the more effective they would be in providing a safe harbor. Firms that could not demonstrate their good faith would remain vicariously liable for the actions of their errant employees.

These incentives are powerful motivators. Experience with the sentencing guidelines for federal crimes and with the antitrust enforcement authorities' efforts at achieving voluntary compliance have shown that firms are willing to put vigorous compliance programs in place even when the potential benefits may be quite limited. Further examples of this sort of policy can be found in the extensive compliance programs defense contractors put in place during the late 1980s in the wake of the spare-part scandals. These programs highlight manufacturers' efforts to work out a more effective relationship with the Department of Defense. Moreover, such incentives can prompt broad change throughout an entire industry. As some firms implement compliance programs, pressure mounts on others to do the same.

The incentive to create a safer product than is provided by the risk of a punitive-damage verdict ought to be viewed in the context of other nonlegal inducements that are considerably more powerful today than they ever have been. For instance, enhancing and protecting the brand image of a product is essential for most manufacturers to succeed in the marketplace. Since safety is an essential element of the brand image for any product that has a potential to cause harm, no firm in business for the long haul can afford to sully its image with a safety concern. The unquenchable thirst of investigative reporters, the diligence of consumer groups, the surveillance of the regulatory authorities, the demands of customer satisfaction, and the blazing speed of the Internet in communicating product dissatisfaction provide firms with powerful reasons to avoid cutting corners in the area of safety. Indeed, market forces do a good job of making manufacturers attentive to the risk of harm to customers. They do such a good job, in fact, that some have argued that there is little need to subject firms to punitive damages to control their behavior, particularly when consumer information about dangerous products is relatively good.21

Of course, the safe harbor provided by rigorous safety procedures would not change a manufacturer's duty with respect to safety defects that became evident after its
product had been sold. Every good-faith safety compliance procedure would have to include establishing a process for monitoring the safety performance of products in use. Customer complaints; reports from the field sales force, dealers, and distributors; inquiries from regulatory bodies; lawsuits; and information from other sources would have to be collected and analyzed to identify safety problems. When evidence appeared suggesting that a product was causing injuries, the manufacturer would have to investigate. This reevaluation of the adequacy of the product’s safety and the decisions based on the reevaluation—for example, issuing warnings or conducting a recall—could provide independent grounds for punitive-damage claims if those decisions exhibited flagrant indifference to safety.

A similar defense might be appropriate in other sectors as well. Many punitive damage awards have occurred in the financial services area in cases where consumers sustained relatively small economic losses. Here juries need to distinguish between firms that are training their sales forces to dupe consumers and those in which a salesman or other agent takes unfair advantage of a customer contrary to the firm’s reasonable sales guidelines.

The “good-faith compliance program” safe harbor would not affect every product liability case. For example, where the product as a whole presented unreasonable safety risks that should have been foreseen and where the decision to market a product with known safety risks was taken consciously by the company’s management, a good-faith defense would not work. A punitive-damage award in such cases would be based on the conduct of the firm’s management, not on that of low-level agents who acted contrary to policy.

A GOOD-FAITH DEFENSE WOULD BENEFIT CONSUMERS AND IMPROVE SAFETY

What consequences would flow from adopting a good-faith compliance program in the near term? There is little doubt that large firms would undertake a review of their safety policies and procedures and strengthen them, if necessary. The extent to which smaller firms would follow is open to debate. However, the affirmative defense suggested here may not be as relevant to smaller firms because senior managers’ direct supervision of the conduct in question (e.g., a design decision) is more likely in small firms. In any event, lawyers would almost certainly gear up marketing programs to sell the service of designing and reviewing compliance programs. Other experts would probably do the same. The key question is whether these changes would be cosmetic or substantive.

Considering the powerful incentives firms already have to design safe products to meet consumer demands, to
be competitive, to comply with regulations, and to protect the brand image, the added inducement provided by legal considerations should guarantee a positive impact on safety. Even if the added inducement to avoid punitive damages resulted in little substantive change in policy for firms already operating with a strong safety orientation, legal review might well lead to the adoption of better documentation of these procedures. The end result might be language that is more transparent, more clearly stated, and less dependent on firm and industry jargon and unstated assumptions and practices. In turn, compliance, particularly by new employees, would be enhanced.

A good-faith defense would also impact the way in which product liability cases are tried. Instead of excluding on grounds of irrelevance evidence about the overall safety of a product and its safety in relation to competitive products—as often happens—the rule suggested here would broaden the context in which decisions to apply punitive damages would be made. The jury would be required to consider the overall design effort and how effective it was in providing safety in all circumstances, not just the specific design decision that led to the plaintiff’s injury. Admitting such evidence would provide additional motivation to design safe products.

**Better Punitive-Damage Rules Could Strengthen Government Standards**

The process by which juries award punitive damages could also be beneficially standardized if state and federal courts adopted more explicit rules about the legal consequences of good-faith compliance with government standards. Under current law, compliance with an applicable federal safety standard is not a defense in a product liability case, and it is not a defense to a claim for punitive damages. However, failure to comply with such a standard is conclusive as to liability and invites a claim for punitive damages. While there clearly are important public policy considerations that demand the question of compliance to be irrelevant when determining underlying liability, these concerns are simply not persuasive in the context of whether or not to also award punitive damages. Indeed, allowing defendants to offer proof that they complied with the most relevant standards when faced with a claim of punitive damages would both improve public safety in a number of ways and properly reward good-faith compliance efforts.

The principal argument against the “government standards” defense is that such standards provide only “minimum” safeguards and even sometimes fall short of that weak objective. It must be conceded, however, that public officials do not normally set standards that reflect a “flagrant indifference to public safety,” and if they do, they should be called to account. A rule,

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"A good-faith defense rule would broaden the context in which decisions to apply punitive damages are made."

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22The new Restatement of the Law, Third: Product Liability covers the “government standards” issue in the context of liability for compensatory damages, but does not discuss the impact of compliance on a claim for punitive damages.
therefore, that examines the legitimacy of the standard, including the efficacy of the rule-making process, could give incentives to the regulatory agency to provide adequate safety in its rules and to firms to cooperate by furnishing complete and accurate information and fairly assessing the feasibility of proposed standards.

These objectives could be accomplished without making compliance an absolute defense to a claim for punitive damages. For example, the rule could provide that compliance with an applicable federal safety standard constituted prima facie evidence of good faith and would shift the burden of proof to the plaintiff to show by "clear and convincing evidence" that either that (1) the defendant is guilty of fraud on the agency, (2) clear advances in the state of the art—implemented since the standard was adopted but before the defendant's product was designed—have rendered it manifestly obsolete, or (3) the standard itself reflects a flagrant indifference to safety.

If the defendant has not been honest in dealing with the agency during the rule-making process, it should not be permitted to use the rule that followed from such a flawed process to avoid liability for punitive damages. An absolute defense based on compliance with government standards would also leave open the possibility that a rule that was appropriate when adopted might become obsolete over time. Generally, designs adopted following the effective date of the standard would be protected. However, when clear advances in the state of the art had been adopted by other firms before the defendant's product was introduced, and the standard had not been revised to reflect these developments, the rule ought not to block the plaintiff from showing that the design adopted by the defendant exhibits a flagrant indifference to safety even though it complies with the standard.

The final circumstance in which the prima facie defense of compliance with an applicable federal safety standard could be overcome is when the standard itself is so inadequate that it is found to reflect a flagrant indifference to safety. That circumstance might arise either as the result of gross misconduct by the agency or because the agency was misled by one or more of the regulated firms other than the defendant. In either case, the defendant, as in instances where the state of the art has rendered the standard manifestly obsolete, should not be allowed to adopt—or be free from liability if it adopts—a design that is grossly inadequate simply because it complies with an existing government standard. Allowing the defense in such circumstances would free firms from the obligation to examine carefully during the design process every aspect of a product that affects safety, whether covered by a federal safety standard or not.

The proposed standard would offer the following benefits:

- Firms would be encouraged to exercise great care to achieve compliance with federal standards.

- Firms would be encouraged to exercise great care in the rule-making process to provide adequate and truthful information.

- Regulators would be encouraged to act responsibly in setting minimum standards.

- Firms would likely be encouraged to achieve higher margins of safety beyond that required by the standard—pleasing safety advocates even while worrying some economists that the added safety margins were not worth the costs.

- The risk that punitive damages would be applied in inappropriate circumstances would be mitigated.

- In the case of products with a long life such as automobiles, tractors, construction equipment, and aircraft, the standard would help juries and other finders of fact avoid the tendency to evaluate product safety in light of the current state of the art.

- It would call attention to the need to revise standards that are inadequate to protect public safety.

- It would encourage firms not to rely on obsolete federal standards in making design decisions.

The current ill-defined standards for imposing punitive damages, although not yet held to have constitutional dimensions, fail to achieve the objectives of providing a real and well-targeted deterrent to unwanted corporate behavior. Standards that encourage firms to adopt good-faith programs to assure substantial and serious attention to safety in the product development process and monitoring of their products in the field could provide real public benefits. Further development of the rules applicable to a government standards defense also could have the effect of inducing firms to strengthen their commitment to deal honestly with regulators in meeting standards and in adopting designs that meet the current state of the art when standards have become obsolete. ▲
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