NONLEGAL SANCTIONS AND DAMAGES: AN ECONOMIC ANALYSIS

BY

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INTRODUCTION

The legal system does not function in a vacuum. Different acts that are governed by legal rules are at the same time governed by social norms. These social norms are in many cases enforced by a set of nonlegal sanctions. These nonlegal sanctions include internal sanctions such as guilt, and external sanctions such as refusals to interact with the offender, shaming, and even private violence.1 This article focuses on the question how should courts set the level of damages in cases in which a nonlegal sanction is applied to the defendant in addition to the legal sanction.

Social norms have been analysed by the economic analysis of the law for many years. This inquiry focused initially on the unique characteristics of nonlegal systems within closely-knit societies and the possibilities of private ordering,2 and has

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broadened to issues related to public law. More recently, an additional line of social norms literature has turned to develop more general theories as to the origin of social norms, and the relationship between social norms and the law. The combined power of these studies clearly demonstrates the seriousness with which law and economics scholars treat social norms.

At the same time an endless amount of literature has been devoted by the economic analysis of the law to the design of optimal damages rules. In the context of tort law these studies have focused on the social goal of minimising the costs of accidents, while in the context of contract law these studies have focused on the selection of contract remedies that maximise the contractual surplus. Nevertheless, despite the magnitude of this literature, in almost all economic models of optimal damages nonlegal sanctions are assumed away.

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6 An excellent overview of the economic analysis of social norms can be found in Eric Posner's study of the issue, see: Posner, supra note ____.


9 For some examples of writers explicitly assuming nonlegal sanctions away see, e.g., Richard Craswell, Precontractual Investigation as an Optimal Precaution Problem, 17 J. LEG. STUD. 401, 407
Given our current understanding of the importance of social norms and nonlegal sanctions it is necessary to incorporate nonlegal sanctions into our analysis of optimal remedies since continuing to ignore the effects of nonlegal sanctions might result in systematic errors in the level of sanctions. If for example the “optimal” sanction that courts apply to tortfeasors is usually enhanced by a supplemental nonlegal sanction, then potential tortfeasors are actually facing a much larger expected sanction than the “optimal” sanction applied by the courts. Thus, such a sanctioning regime might over-deter potential tortfeasors driving them to take excessive care or avoid beneficial (yet risky) activities.

In a recent article Cooter and Porat ended this long caveat and addressed directly the question of how should courts that wish to minimise social costs calculate damages given the existence of nonlegal sanctions. The conclusion that Cooter and Porat reached was that generally nonlegal sanctions should be deducted from damages. Yet this conclusion is built on the problematic claim that in many cases nonlegal sanctions transfer benefits to third parties and that these benefits should be deducted from the sanction imposed on wrongdoers. Furthermore, Cooter and Porat

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10 Robert Cooter & Ariel Porat, _Should Courts Deduct Nonlegal Sanctions from Damages?_ 30 J. LEGAL STUD. 401 (2001). Predating this study Charny has also addressed the issue of nonlegal sanctions; see David Charny, _Nonlegal Sanctions in Commercial Relationships_, 104 HARV. L. REV. 373 (1990). Nevertheless in his study Charny did not address the question of how should the existence of nonlegal sanctions affect the level of damages awarded by courts.

11 Cooter & Porat, _id._ at 415-7.

12 A closer examination of the benefits pointed out by Cooter and Porat leads to the conclusion that they should not be deducted from the sanction imposed on wrongdoers. For example, Cooter and Porat propose that the benefit of deterrence created by nonlegal sanctions should be deducted from damages. This claim can be criticised on several grounds. As a starting point it should be noted that the benefit of deterrence is not unique to nonlegal sanctions since both legal and nonlegal sanctions deter potential wrongdoers and create this benefit. Thus, the question that should be asked is whether the benefit of deterrence in general should be deducted from sanctions. As to the benefit itself, deducting the benefits of deterrence from sanctions is undesirable since it will undermine deterrence. The reason for this is
implicitly assume in their analysis that the adoption of the proposed rule will not affect the level of nonlegal sanctions.

The analysis presented in this article on the question of the design of damages given the existence of nonlegal sanctions will continue to focus on the goal of achieving optimal deterrence, yet it will introduce to this discussion two themes that were previously ignored by the literature in this context. The first is the evaluation of the social powers that drive the creation of nonlegal sanctions. It will be shown that understanding the social powers that drive the creation of nonlegal sanctions is a crucial step in order to build a theory of nonlegal sanctions and damages. The second theme that will be introduced, and that is built on the previous one, is that the law cannot treat nonlegal sanctions as a given social phenomena that will remain constant no matter how it treats them. Rather, we shall see that the law is an endogenous factor in determining the level of nonlegal sanctions. Mapping the potential endogenous effects of the law on the level of nonlegal sanctions is a complex task since a large number of social variables must be accounted for. Nevertheless even if the
complexities of this task prevent us from reaching definitive conclusions at this time; these effects must be accounted for in the analysis.

This article is organized as follows: Section I discusses the different forces driving the creation of nonlegal sanctions. In this discussion I will point out three major forces that drive individuals to change their attitudes towards wrongdoers for the worse. These forces are the existence of a preference for sanctioning, the infliction of sanctions in order to avoid a negative reaction from others, and adjustment to new information revealed by the wrongful act. Section II opens the analysis of the relationship between legal and nonlegal sanctions, and deals with the potential endogenous effects of the law on the level of nonlegal sanctions. It will be suggested that the law does affect the level of nonlegal sanctions in different ways, and that these effects depend on the social forces that underline the nonlegal sanction. Furthermore it will be shown that estimating the potential magnitude of the endogenous effects of the law is a complicated task that requires an extensive amount of information. In Section III I will turn to evaluate how should the law treat nonlegal sanctions. My discussion will first map out the advantages and disadvantages of legal and nonlegal sanctions. Then I will turn to analyse whether it is desirable to deduct nonlegal sanctions from damages with respect to each type of nonlegal sanction identified in Section I. My analysis will show that adopting such rules could create uncertain endogenous effects, and therefore I will introduce the concept of a selective deduction of nonlegal sanctions from damages in specific cases in which nonlegal sanctions are set at extremely high levels. In Section IV I will apply the general theory developed in the previous sections to the specific context of reputational sanctions in
commercial transactions. It will be shown that nonlegal sanctions are a tool that contracting parties use in order to create optimal contract remedies given the drawbacks of legal sanctions. Thus, I will argue that the law should take a restrictive approach towards nonlegal sanctions in this context and treat them as if they were a remedy that the contracting parties agreed to ex-ante. Accordingly, it will be suggested that the selective deduction rule should not be applied in this context.

I. THE DECISION MAKING PROCESS OF INFlicting NONLEGAL SANCTIONS

In this section I will examine why individuals agree to participate in the act of sanctioning other members of society. The premise that will underline my analysis is that the infliction of sanctions comes at a cost to the individuals that apply them. Thus, rational individuals will apply a sanction to other individuals only when the benefits they gain from applying the sanction exceed the cost of applying the sanction. Individuals are expected to optimise the level of sanctions they inflict at a level at which the marginal utility they gain from the infliction of the sanction equals the marginal cost of inflicting the sanction.

The cost of inflicting nonlegal sanctions depends on the kind of sanction that is being applied. One type of sanction is a passive one in which the inflictor of the

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13 See Richard A. Posner, THE ECONOMICS OF JUSTICE, 211 (1981) (pointing out that in the absence of compensation an individual must derive utility from a vengeful act in order to be motivated to commit it). It should be noted that some scholars that dealt with the question of the creation of nonlegal sanctions have argued that nonlegal sanctions are created on the basis of a costless mechanism, see Richard H. McAdams, supra note ____ at 355. In his analysis McAdams focuses on withholding esteem as a costless basis on which nonlegal sanctions are build. Yet since even withholding esteem requires some action on part of the individuals that are doing the withholding it would seem that such a sanction does require the individuals who inflict it to bear at least some costs. Hence, we cannot resolve the cost benefit analysis by assuming that there is no cost.

14 This benefit can also be in the form of avoiding a harm that will be inflicted on the individual if he does not participate in the act of sanctioning.
sanction chooses to eliminate or lower its demand for the products or services of the wrongdoer. For example, a consumer that chooses to boycott the products produced by the wrongdoer. The main cost of this kind of sanction from the perspective of the consumer is the self-imposed limitation on his ability to choose. A sanctioning consumer is forcing himself to consume the next best product in the market, and the difference between the value of the first best product and the second best product reflects the cost of enforcing the boycott.\textsuperscript{15} A second type of sanction is an active one in which the inflictor of the sanction takes action that harms the wrongdoer. The infliction of active sanctions comes at a cost to the inflictor of the sanction as well. For example, in the case of shaming, the individual inflicting the sanction needs to invest time and mental resources into the act of shaming and assumes the risk that the sanctioned individual will retaliate against him.

Turning to the benefit incurred by the party inflicting the nonlegal sanction, it would seem that several different elements compose this benefit. The first of these is a preference for sanctioning wrongdoers.\textsuperscript{16} Such a preference includes a preference for reciprocity and a preference for expressing disapproval of wrongful acts. Reciprocity is the desire of a person who has suffered from the act of another person to inflict harm on that individual.\textsuperscript{17} The preference for reciprocity has been demonstrated in a long line of experiments of ultimatum games in which participants showed a willingness to endure monetary costs in order to sanction individuals that

\textsuperscript{15} A transfer from one product to another might create other costs such as the cost of gathering information in order to choose an alternative product.

\textsuperscript{16} Ernst Fehr & Simon Gächter, \textit{Altruistic Punishment in Humans}, 415 \textit{Nature} 137 (2002) (presenting data supporting the hypothesis that emotions are an important factor behind the act of punishing others).

\textsuperscript{17} A significant line of economic literature has been presented in the past decade on the economics of reciprocity. For a general review of this literature see \textit{generally} Ernst Fehr & Armin Falk, \textit{Psychological Foundations of Incentives}, 46 \textit{Euro. Econ. Rev.} 687, 689-704 (2002).
treated them in a way that they perceived to be unfair. The presence of a preference for reciprocity can be explained by evolutionary models that illustrate why mutants that have a preference for reciprocity have higher reproductive success, and from a game theory perspective suggesting that players can maximize their personal payoffs by adopting a strategy based on reciprocity. Expressive nonlegal sanctions on the other hand are characterized by situations in which a person wants to show his disapproval of acts that treated unfairly other members of society. Such behavior has also been documented in experiments in which participants manifested a willingness to sacrifice their monetary interests in order to sanction individuals who treated other individuals unfairly.


20 Robert Axelrod, The Evolution of Cooperation 27-54 (1984) (showing how a reciprocal strategy can lead to higher payoffs for a player in a repeated prisoners dilemma).

21 To some extent one might wish to view expression as an extension of reciprocity. While reciprocity deals with harms caused to oneself, expression deals with harms caused to others. Members of a society have in some level a connecting bond and a feeling of solidarity. This unclear bond creates a preference for an expression of condemnation when a member of society has treated another member of society unfairly.

22 Daniel Kahneman, Jack L. Kentsch & Richard L. Thaler, Fairness and the Assumptions of Economics, J. OF BUSINESS, S285, S290-S292 (1986). In the first stage of this experiment participants plaid a variation of the ultimatum game in which the alocator needed to divide between himself and a recipient $20. The alocator was able to divide the $20 either equally or by allocating $18 to himself and allocating $2 to the recipient. In the second stage of the game participants were asked to choose between receiving a payoff of $12 that was to be shared equally with a player that chose to allocate $18 to himself in the first round and receiving a payoff of $10 that was to be shared equally with a player that chose to allocate $10 to himself in the first round. Thus, the players in the second round were asked to give up one dollar in order to sanction a player that acted unfairly in the first round towards another individual. The results of the experiment were clear - 74% of the players in the second round chose to sacrifice their monetary well-being in order to sanction individuals that treated other players unfairly. See also Ernst Fehr, Urs Fischbacher & Simon Gächter, Strong Reciprocity. Human Cooperation and the Enforcement of Social Norms, 13 HUMAN NATURE - AN INTERDISCIPLINARY BIOSOCIAL PERSPECTIVE 1, 16-7 (2002).
Yet the existence of a preference for sanctioning is not the only explanation for the benefits created by the infliction of nonlegal sanctions. A second benefit of nonlegal sanctions is that participating in acts of sanctioning can induce positive reactions from others and vice-versa – not participating in acts of sanctioning may trigger negative reactions from others. The fact that participation in acts of sanctioning affects the attitudes of others towards the party inflicting the sanction may be explained by two alternative theories.

The first of these theories is the signaling model of social norms. In this model individuals are either “co-operators” who care about future payoffs (have a low discount rate), or “cheaters” who care about present payoffs (have a high discount rate). Both types of players are situated in a repeated game in which co-operators maximise their payoffs by interacting among themselves. In order to achieve this goal co-operators can use costly signals that only individuals that expect the high cooperative payoff can afford to send. Within this framework the cost incurred by

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23 Such expressive behavior can in fact be found in the context of consumer boycotts (see: Monroe Friedman, CONSUMER BOYCOTTS 12-3 (1999)). An historical example of such an expressive nonlegal sanction is the Jewish boycott against German goods during World War II. The organizers of this boycott – especially during its later years - could not truly assume that it will bring about any substantial change in the policies of Germany at the time towards Jews. The goal of participating in this boycott was to allow American Jews to take some action, futile as it might be, rather than do nothing. See: William Orbach, Shattering the Shackles of Powerlessness: The Debate Surrounding the Anti-Nazi Boycott of 1933-41, 2 MODERN JUDAISM 149, 161-6 (1982)). Nevertheless it should be noted that participation in this boycott was driven by other forces as well (see infra note ______).

24 The relation between signaling and social norms has been extensively examined and thus I will explain the nature of the signaling model in the text above only briefly. For further analysis see Eric A. Posner, Symbols, Signals, and Social Norms in Politics and the Law, 27 J. LEGAL STUD. 765 (1998) [hereinafter: Posner, Symbols]; and Posner, supra note ______, at 11-35.

25 To illustrate this description it might be useful to view the numerical example presented in Posner, Symbols, id. at 769-70. In this example the world is divided to “senders” and “receivers” that can interact among themselves. Both senders and receivers are composed out of “co-operators” and “cheaters”. In the game a cooperating receiver needs to decide whether to deal with a sender. The players in Posner’s cooperation game face the following payoffs: If the receiver does not cooperate with the sender the payoff for the sender and the receiver is $0. If the receiver cooperates and the sender is a cheater the sender will cheat and gain $2 while the receiver will lose $2. Finally, if the receiver will cooperate and the sender is a co-operator they will both gain a payoff of $6. Posner further
the sanctioning party is precisely what makes the infliction of the nonlegal sanction a credible signal. Individuals that will not participate in the act of sanctioning will be perceived as non-co-operators and will find it difficult to engage with members of the sanctioning group. Furthermore, social norms that require an infliction of a nonlegal sanction have content in the sense that the act of sanctioning expresses disapproval of the wrongful act. This social context can create a cost structure for the ‘sanction signal’ in which signaling is more costly for cheaters than it is for co-operators. If such a cost structure exists it will render superior signals since it will allow to lower the amount of resources spent on signaling.

An alternative theory explaining why the infliction of nonlegal sanctions may be required in order to induce positive reactions from others was presented lately by

assumes that there is some random act, say, saluting the flag, which costs both parties $3 and that receivers believe that indicates cooperation. Under these assumptions a separating equilibrium may emerge in which the receiver will cooperate with players who salutes the flag, and will refuse to deal with players who does not salute the flag. Under such a strategy cheaters will not be able to deal with the co-operator since their payoff of $2 is insufficient to cover the cost of the signal, they will prefer not to deal and gain $0 than signal and remain with a net payoff of $-1. On the other hand co-operators that earn $6 can afford to send a signal at the cost of $3.

26 An illustrative example can be found in the case of consumer boycotts. As I have pointed out earlier these boycotts come at a cost to consumers in the form of sub-optimal consumption. It has been argued that one of the reasons that consumers agree to participate in such costly boycotts is the fact that they help them gain group membership or approval (see: Sankar Sen, Zeynep Gurhan-Canli & Vicki Morwitz, Withholding Consumption: A Social Dilemma Perspective on Consumer Boycotts, 28 J. CONSUMER RESEARCH 399, 401). The theoretical explanation for this argument is that participation in a consumer boycott can serve as a signal for ones willingness to cooperate with group members. This analysis can serve to explain the phenomena of the publication of names of individuals who do not participate in boycotts. A signaling equilibrium requires that parties hold good information regarding the signaling acts of others. Without such information the act of signaling would be futile. See Dennis E. Garrett, Consumer Boycotts: Are Targets Always the Bad Guys, 58 BUS. & SOC. REV. 17, 19-21 (1986) (pointing out the phenomena in general and its moral problems). See also Friedman, supra note ______ at 177 (presenting a case in which the names and addresses of violators of a boycott aimed against a milk company were publicized); and W. Muraskin, The Harlem Boycott of 1934: Black Nationalism and the Rise of Labor-Union Consciousness, 13 LABOR HISTORY 361, 364 (1972) (presenting a case in which the photographs of boycott violators were published in a local newspaper).

27 In the terms of the numerical example presented in note ______ supra assume that the cost of the signal is still $3 for the cheaters but only $1 for co-operators. Such a signal is superior since it allows the creation of a separating equilibrium at a lower cost.
Mahoney and Sanchirico. In their paper Mahoney and Sanchirico introduce a concept of an upper norm that requires members of society to sanction other members that deviate from the general norm. Under such a norm individuals that do not punish defectors are deviating themselves and will be sanctioned for not fulfilling their duty to sanction. Thus, if individuals do not have exceptionally high discount rates they will participate in the act of sanctioning in accordance with the social norm requiring them to do so.

One last force that might bring people to change their attitude towards wrongdoers for the worse is that wrongful acts might convey new information as to the nature of the wrongdoer. In many cases the discovery of the wrongful act can serve as an indicator of the fact that the wrongdoer belongs to the type of individuals that tend to commit wrongful acts. Thus, quite naturally, once members of society learn what type of person the wrongdoer is, and what are the specific risks associated with dealing with him are, they will internalise this new information into the decision of how to interact with the wrongdoer in the future. It should be noted that within this category of nonlegal sanctions the inflictor of the sanction is not gaining any utility from applying the sanction as such. Rather he is simply re-evaluating his relationship with the wrongdoer, given the fact that the wrongdoer is a wrongdoer.

29 Id. at 18-26. Mahoney and Sanchirico analysis is a game theoretic analysis of strategies in a repeated prisoners dilemma. In their paper they introduce a strategy to this game – def-for-dev (defect-for-deviate). One of the main practical effects of this strategy is that it requires from parties to sanction defectors, and views those who do not do so as deviators that should be sanctioned.
30 Id.
31 The case studies of consumer boycotts provide numerous examples of nonlegal sanctions that were effective only because they were rigorously enforced by the organizers of the boycotts. For example the Jewish boycott against German goods during World War II was strictly enforced by nonlegal sanctions (see Friedman supra note ____ at 136).
In this section we have seen that the decision to inflict a nonlegal sanction like any other decision is the product of a cost benefit analysis preformed by the party inflicting the nonlegal sanction. The main forces that I have identified as the forces driving the creation of nonlegal sanctions are individual preferences (that include reciprocity and expression), avoiding negative reactions for not sanctioning (by signaling or by adhering to an upper sanctioning norm), and adjustment to new information. None of these forces is necessarily predominant, and any given case might involve more than one of these forces.

II. AN ENDOGENOUS MODEL OF NONLEGAL SANCTIONS AND THE LAW

After understanding the forces driving the creation of nonlegal sanctions we can turn to the question how will the legal treatment of nonlegal sanctions affect their level. The legal rule that I will focus my discussion on is a rule according to which nonlegal sanctions are deducted from damages that courts award (hereinafter a “deduction rule”). This deduction can either be complete - meaning that all of the nonlegal sanction will be deducted from damages, or partial – meaning that only a certain percentage of the nonlegal sanction will be deducted from damages.\(^{32}\)

The initial motivation for the adoption of such a deduction rule is to prevent a situation in which potential wrongdoers face excessive sanctions. Potential wrongdoers do not differentiate between legal and nonlegal sanctions when making decisions as to care levels and activity levels, since what they are concerned about is

\(^{32}\) An equivalent to a partial deduction rule can be in situations in which courts do not hold prefect information as to the magnitude of the nonlegal sanctions. In such situations even under a complete deduction rule courts will be able to deduct only those nonlegal sanctions that they are aware of.
the total magnitude of harm inflicted to them as sanctions. Thus, if courts are tailoring sanctions that supposedly give wrongdoers proper incentives, wrongdoers are in fact facing excessive sanctions. As a result of these excessive sanctions wrongdoers will be over-deterred from engaging in potentially beneficial (yet risky) activities or will be induced to take excessive care.

Despite this initial argument in favor of a deduction rule courts did not adopt such a rule thus far. A party that breached a contract and as a result suffered from a consumer boycott cannot ask a court to lower the damages it awards the aggrieved party because it has suffered a sufficient nonlegal sanction. This general rule has some nuanced exceptions in which courts do adjust the sanctions they inflict to wrongdoers in order to take into account supplemental legal or nonlegal sanctions that were applied to wrongdoers. For example, in the context of criminal sanctions courts regularly take into account the supplemental nonlegal sanctions that are inflicted to wrongdoers.33 Another legal context in which courts are willing to lower the legal sanction because of the existence of a supplemental legal sanction is that of punitive damages.34 This practice has been endorsed by scholars as efficient on the basis of the over-deterrence argument presented above.35

In order to design an optimal legal policy towards nonlegal sanctions we must first evaluate how such a policy might affect the level of nonlegal sanctions. One

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33 SENTENCING GUIDELINES IN ANTITRUST, 91 (Robert E. Hanberg et al. eds., 1999) (pointing out that the impact of the conviction on the defendant’s personal life, can affect sentencing). In addition supplemental legal sanctions, such as compensating the victim of the act, can serve as a factor that will cause a reduction of the criminal sanction (see MODEL PENAL CODE §7.01(2)(f) (1985)).

34 Generally, the fact that the wrongdoer was subject to a criminal sanction may justify a reduction of the punitive damages applied to him. See Green Oil Co. v. Hornsby, 539 So. 2d. 218, 223-4 (Ala. 1989) (quoting Aetna Life Ins. Co. v Lavoie, 505 So. 2d. 1050, 1062 (Ala. 1987) (Houston, J., concurring specially)). This view was adopted by the United States Supreme Court in Pacific Mut. Life Ins. Co. v. Haslip, 499 U.S. 1, 22 (1991).

35 Polinsky & Shavell, supra note ____ at 926-7.
possible answer to this question might be that the law is an exogenous factor with respect to the decision making process of inflicting nonlegal sanctions. Under this assumption the law may tailor an optimal rule with regard to nonlegal sanctions and the selection of this rule will not affect the level of nonlegal sanctions.\textsuperscript{36} In this Section I will argue that such an assumption is implausible, and that a complete model of nonlegal sanctions and damages must include the potential endogenous effects of the law on the level of nonlegal sanctions. The main motivation for this claim is the fact that both legal and nonlegal sanctions occupy the same domain - the domain of reacting to wrongful acts.

The analysis presented in this article focuses on specific assumptions with respect to the timing of nonlegal sanctions. For the duration of my analysis I assume a timing structure in which the legal system moves first and sets a benchmark legal sanction and a deduction rate. Following this individuals choose the level of nonlegal sanctions not knowing what the level of the legal sanction in the specific case will be. Nevertheless I assume that these individuals do hold information as to the observed legal sanction\textsuperscript{37} in similar prior cases.\textsuperscript{38} Finally the legal sanction is applied according to the policy set in the first period.\textsuperscript{39}

\textsuperscript{36} For the most part, the model presented by Cooter and Porat regarding the deduction of nonlegal sanctions from damages was an exogenous model in the sense that it assumed that the law could adopt a deduction rule without affecting the expected level of nonlegal sanctions. An exception to this is the fact that Cooter and Porat do take notice of the fact that courts might be able to induce nonlegal sanctions, Cooter & Porat, supra note \underline{____} at 413.

\textsuperscript{37} By the term observed legal sanction I am referring to the legal sanction that was actually inflicted to wrongdoers in similar cases (i.e. the benchmark legal sanction minus the nonlegal sanction multiplied by the deduction rate).

\textsuperscript{38} It should be noted that courts may try to induce individuals to inflict nonlegal sanctions before they set the specific legal sanction by bifurcating the trial hoping to trigger the nonlegal sanction by the determination of liability. If such a scheme will be successful courts will be able to calculate damages while knowing the nonlegal sanction that the wrongdoer was subjected to.

\textsuperscript{39} This is not to say that this is the exclusive description of the timing of nonlegal sanctions. It is quite clear that in some cases nonlegal sanctions are second in time to legal sanctions, for example there is a
I will now turn to evaluate the potential endogenous effects of the law with respect to each category of nonlegal sanctions presented in Section I.

1. Nonlegal Sanctions Driven by Personal Preferences

The first category of nonlegal sanctions I identified in the previous section is nonlegal sanctions that are driven by a preference to inflict harm to wrongdoers. Within this category it can be expected that legal sanctions will affect nonlegal sanctions in two ways. The first is the effect that the level of legal sanctions has on the level of nonlegal sanctions. The second is the effect of legal rules that are aimed directly towards nonlegal sanctions such as a deduction rule have on the incentives of individuals to participate in the act of sanctioning.

(a) The Effect of the Level of the Legal Sanction

The first effect of the law on nonlegal sanctions is the effect that changes in the level of the legal sanction will have on the level of nonlegal sanctions. The relationship between the level of the legal sanction and the level of nonlegal sanction is a complex one, since the level of legal sanctions is expected to have two competing and contradicting effects on the level of the nonlegal sanction.

On one hand, a plausible assumption regarding the effect of the level of the legal sanction on the level of the nonlegal sanction may be that individual’s demand

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well-documented phenomena of nonlegal sanctions that are applied to sex-offenders after they are released into the community. These timing situations will be dealt with as part of a larger project.

40 See supra notes ____ and accompanying text.
for inflicting nonlegal sanctions diminishes with the rise of the legal sanction.\footnote{There is a very limited amount of empirical data relating to the question how does the level of the legal sanction affect the level of the nonlegal sanction. Some empirical support for the assumption in the text can be found in Lott's study of nonlegal sanctions that are applied to individuals convicted in drug related offences. In this study Lott found that individuals with longer prison sentences had higher post conviction income (i.e. a lower nonlegal sanctions), though these results were not statistically significant. John R. Lott, Jr., An Attempt at Measuring the Total Monetary Penalty from Drug Convictions: The Importance of an Individual’s Reputation, 21 J. LEGAL STUD. 159, 176 (1992).} Under this assumption individuals wish to see that wrongdoers suffer from an “appropriate” sanction. Since legal sanctions and nonlegal sanctions produce the same outcome – the infliction of harm to the wrongdoer – these two may serve as substitutes (for the duration of this article I will refer to this effect as “the substitution effect”).\footnote{There is a long line of literature that demonstrates that the law has evolved as a substitute for nonlegal sanctions, specifically for revenge based nonlegal sanctions. Perhaps the most famous such claim can be found in Oliver W. Holmes, Jr., THE COMMON LAW, 1-38 (1881). In his first lecture on the law Holmes argues that various forms of legal liability developed from the concept of revenge. For a more contemporary analysis of the connection between law and revenge see Richard A. Posner, LAW AND LITERATURE, 49-60 (2d, 1998) (analysing the evolution from revenge to law). For a model of the development from a revenge based society to a legalistic society see, e.g., Geoffrey MacCormack, Revenge and Compensation in Early Law, 21 AMER. J. OF COMPARATIVE LAW 69, 74 (1973).} The substitution effect will be determined by factors such as do the sanctioning individuals hold sufficient information in order to determine what an appropriate sanction is, and do individuals view sanctions inflicted by the legal system as a sufficient substitute for personally inflicted sanctions.\footnote{It would seem that from this perspective there might be some difference between nonlegal sanctions that are driven by personal reciprocity and nonlegal sanctions that are driven by expression. One may assume that in the realm of expression in which parties are inflicting sanctions due to harm caused to others and not themselves the demand for a sanction inflicted personally rather than a sanction inflicted through the legal system is lower than in the realm of personal reciprocity, which by its very nature is personal. Thus, the effect of a deduction rule is expected to be stronger with respect to expression than it is with respect to personal reciprocity.} On the other hand, a second plausible assumption may be that individual’s demand for inflicting a nonlegal sanction rises with the rise of the level of the observed legal sanction.\footnote{Some empirical support for this effect of legal sanctions on nonlegal sanctions can be found in Lott’s study of nonlegal sanctions in the context of larceny and theft. In this context Lott found that longer prison sentences are consistently related to lower post conviction income. See John R. Lott, Jr., Do We Punish High Income Criminals too heavily?, 30 ECON. INQUIRY 583, 597 (1992). It should be noted that part of the decline in the income of individuals that serve prison sentences could be explained by the fact that they lose part of their human capital during their stay in prison – a factor that is irrelevant} Under this assumption legal sanctions
serve as a signaling device for society that a wrongdoer deserves to be subject to a nonlegal sanction. Thus, when courts set high legal sanctions in prior similar cases members of society follow in the footsteps of the courts and raise the magnitude of nonlegal sanctions in such cases (for the duration of this article I will refer to this effect as “the signaling effect”). Obviously the substitution effect and the signaling effect work in opposite directions, and, thus, the effect of a deduction rule will differ depending on the specific sanctioning preferences.

(b) The Effect of Rules that are Aimed Directly Towards Nonlegal Sanctions

Specific legal policies that target the existence of nonlegal sanctions, such as deduction rules, are expected to have an additional effect on the level of nonlegal sanctions since in this context individuals who inflict nonlegal sanctions know that the act of inflicting a nonlegal sanction causes a legal reaction in the form of a reduced

in the case of damages. Nevertheless, the data presented by Lott demonstrates that the decline in the income of convicted individuals exceeds any potential loss due to the loss of human capital.

It should be noted that courts may use other tools in order to send signals to society in order to affect the level of nonlegal sanctions. For example, courts can send signals by using judicial rhetoric that encourages a social response in the form of a nonlegal sanction. Legal rhetoric, especially in cases that are in the public eye and in which the court knows that its ruling will be publicised, can transfer information to the public in the same way that the level of the legal sanction does. Once the public hears from the court the appropriate rhetoric it will follow the cue and inflict a nonlegal sanction. Such legal policies are beyond the scope of this article.

Regarding the potential effects of changes in the level of legal sanctions a distinction could be drawn between reciprocity driven nonlegal sanctions and expression driven nonlegal sanctions. In the context of reciprocity it would seem that the dominant effect on the behavior of the inflictors of nonlegal sanctions is the substitution effect. The reason for this is that nonlegal sanctions that are driven by personal reciprocity involve individuals that hold a substantial amount of information as to the facts of the case and therefore have a perception of what an “appropriate” sanction in this case ought to be. On the other hand, in the context of expression it is expected that the signaling effect will be relatively substantial since expression driven nonlegal sanctions involve individuals that are further away from the wrongful act and therefore their perception of the “appropriate” sanction will be affected by the legal sanctions that they observe.
legal sanction. More specifically, the effect of a deduction rule will depend on the effect of the level of the observed legal sanction. If the dominant effect of the level of the observed legal sanction is the signaling effect then the level of the nonlegal sanction is expected to diminish as the deduction rate rises since higher deduction rates will create lower observed legal sanctions that in turn will generate lower nonlegal sanctions. Thus, we can conclude that in this scenario both legal and nonlegal sanctions will diminish with the rise of the deduction rate and that the total sanction wrongdoers face will diminish.

If, on the other hand, the dominant effect of legal sanctions on nonlegal sanction is the substitution effect the picture becomes more complex. In such cases when the deduction rate is sufficiently low the nonlegal sanction is expected to rise in order to substitute for the diminished legal sanction. Yet at some point this substitution effect will become redundant since high deduction rates might render the nonlegal sanctions so ineffective that sanctioning individuals will prefer to save the cost of inflicting nonlegal sanctions and inflict no nonlegal sanction knowing that the wrongdoer will be subjected to the benchmark legal sanction. Nevertheless it should be noted that in this scenario the total sanction is expected to diminish as well. The reason for this is that as long as individuals hold a substitution preference that is not at a one to one ratio, the additional nonlegal sanction they will choose to inflict will always be lower than the reduction of the legal sanction.

47 Other legal rules that deal directly with nonlegal sanctions will also affect the level of nonlegal sanctions. For example, outlawing certain types of nonlegal sanctions will raise the cost of inflicting such sanctions and might cause a reduction in their use.
48 Notice that in the extreme case in which individuals hold a preference to completely substitute for any deduction and inflicting nonlegal sanctions is costless these individuals will only sustain the previous total sanction. Once individuals hold weaker substitution preferences and nonlegal sanctions are costly it can be shown that the substitution will only be partial.
Finally, it should be noted that deduction rules might create other endogenous effects on the level of nonlegal sanctions. For example, the fact that deduction rules will lower the compensation of victims is expected to affect the level of nonlegal sanctions inflicted under such a rule since it is reasonable to assume that individuals inflicting nonlegal sanctions tend to sympathise with the victims of wrongful acts. Hence, once these individuals learn that the act of sanctioning actually harms victims we can expect them to be reluctant to participate in such activity.

In sum it would seem that the law is expected to have strong affects on the level of preference driven nonlegal sanctions individuals will choose to inflict. Nevertheless anticipating the precise effect prior to the adoption of such a rule requires information as to the specific preferences driving these sanctions.

2. Nonlegal Sanctions Driven by the Anticipated Behavior of Others

As we have seen a second force driving the creation of nonlegal sanctions is the fact that others might treat individuals worse if they do not sanction wrongdoers.49 This argument was based both on the signaling qualities of inflicting nonlegal sanctions and on the possibility of an upper-norm requiring the sanctioning of individuals that do not apply nonlegal sanctions towards wrongdoers.

With respect to signaling nonlegal sanctions it would seem that the endogenous effect of the law will be more limited than that of the law with respect to preference driven nonlegal sanctions. The characteristic that makes nonlegal sanctions a good signal is the cost that is incurred by the sanctioning party. Individuals that sanction in order to signal, care about the signal they send, and not about the level of

49 See supra notes ____ and accompanying text.
harm inflicted to wrongdoers. Thus, changes in the total sanction inflicted to wrongdoers as a result of the adoption of a deduction rule will have a more limited effect in the signaling context.

Nevertheless, two possible effects of the law in this context should be pointed out. First, as mentioned above in some cases it is advantageous to use signaling devices that have a content that has different values for “cheaters” and “co-operators”.\(^{50}\) If cheaters find it more costly than co-operators to sanction an act since they do not think that wrongdoers should be harmed, then a deduction rule might lead to the unravelling of such signals,\(^{51}\) and an effective social tool might cease to function since its content will be changed by the legal rule.

Second, the question of why do specific acts end up being used as signals rather then other acts is a complex question that was yet to be fully answered. One possible answer is that signals emerge around focal points.\(^{52}\) These focal points emerge due to different reasons such as historical coincidence and behavioral attributes that can be associated with certain qualities of character.\(^{53}\) Considering the large amount of variables affecting the creation of such focal points, attempting to estimate the possible effects of a deduction rule would be extremely difficult. What should be pointed out is that such effects - both with respect to existing nonlegal sanctions and with respect to the creation of new nonlegal sanctions - are quite possible. Elements such as reciprocity, expression and moral perceptions of an act

\(^{50}\) See *supra* notes _____ and accompanying text.

\(^{51}\) Continuing the discussion of the example presented in notes ____ and ____ *supra* regarding the creation of a separating equilibrium through the act of saluting the flag, if a deduction rule will lower the cost of saluting for cheaters to $1 as well, then the signal will no longer be effective. Cheaters and cooperators will both send the signal at a cost of $1 and end up in a costly pooling equilibrium.


play a role in the creation of a signal, and the fact that the victim of the nonlegal sanction will suffer from a diminished legal sanction due to the nonlegal sanction might effect the creation of a focal point around a nonlegal sanction. Thus, deduction rules might lower the use of nonlegal sanctions as a signaling platform.

The argument can perhaps be better understood through the example of racial discrimination. Racial discrimination is in many senses similar to nonlegal sanctions since it is the infliction of harm to another member of society in order to comply with a social norm, and it can be explained as by the signaling model of social norms.\(^{54}\) According to this model discrimination serves as signal to indicate co-operation among members of the discriminating group. Discrimination may act as a credible signal because it comes at a cost to the discriminator in the form of the forgone opportunities of dealing with members of the group discriminated against and the willingness to bear this cost indicates that the discriminators value the long-term cooperation with members of the discriminating group more than the short term benefits from dealing with members of the discriminated group. Now assume that a legislature that wishes to abolish racial discrimination attempts to achieve this goal by adopting a law under which victims of discrimination receive full compensation from the state for the damages caused to them by acts of discrimination. It is impossible to estimate before hand what the effect of such a law will be on the continuation of discrimination. On one hand, such a law might render the entire act of discrimination

futile and as a result discrimination would tend not to “catch” as a focal point for a signal. Surely if discrimination has not yet developed as a signaling focal point such a law might prevent it from becoming a focal point. Yet on the other hand, the proposed law would not diminish in any way the signaling effect of discrimination. Individuals who choose to discriminate will continue to endure the same cost as a result of sending the signal. From this perspective discrimination can continue to function as an effective signal to indicate cooperation among the discriminating group.

The conclusions pointed out thus far in this subsection continue to hold when we turn to nonlegal sanctions driven by an adherence to an upper-norm requiring that individuals sanction wrongdoers. Individuals participating in such sanctions wish to fulfil their obligation to sanction at a minimal cost and do not hold any preferences as to the harm that is actually inflicted to wrongdoers. Rather, their only concern is to be perceived by others as inflectors of a sufficient sanction that will fulfil their obligation under the upper-norm. Thus there is no reason to expect that such individuals will want to change the level of sanctions they inflict to wrongdoers even if it is deducted from the legal sanction.

A qualification should be added in this context as well. It might be argued that in addition to the upper-norm that regulates the act of sanctioning there exists an upper-upper-norm that regulates what level of sanctioning is required.55 If such an upper-upper-norm exists its content could be determined by concepts of reciprocity and appropriate sanctions. In such a case this type of sanctions will become similar to preference

55 In their model Mahoney and Sanchirico do not deal with the question of the level of nonlegal sanctions since their model is constructed in the form of a repeated prisoners dilemma in which the only possible sanction towards the wrongdoer is defecting (Mahoney & Sanchirico, supra note ____). In more complex situations players might be able to inflict different levels of sanctions to wrongdoers.
driven sanctions. While in the context of preference driven sanctions each sanctioning party decides separately on the appropriate level of the nonlegal sanction, in the context of a sanctioning upper-norm a collective judgement through the mechanism of the upper-upper-norm will decide on the appropriate level of the nonlegal sanction. Hence, to some extent we might expect to see some of the endogenous effects relevant to preference driven nonlegal sanctions in this context as well.

In sum, it would seem that with respect to nonlegal sanctions driven by anticipated behavior of others the law is expected to have a limited effect on the chosen level of the nonlegal sanction. The potential effects that we have identified point to the conclusion that a deduction rule might diminish to some extent the level of the nonlegal sanctions. Yet as we have seen a precise evaluation of this effect is difficult – if not impossible - to conduct before hand given the limited information we hold regarding the social structures that drive such sanctions.

3. Nonlegal sanctions driven by adjustment to new information

The final force driving the creation of nonlegal sanctions identified in the previous section was adjustment to new information.\footnote{See supra notes _____ and accompanying text.} Information driven nonlegal sanctions can be characterized by the fact that they reflect an independent decision of the sanctioning party that is maximising its own welfare given the new information regarding the wrongdoer and not a desire to harm wrongdoers. This fact simplifies the discussion of the endogenous effects of the law on such sanctions. Once the motivation of the behavior of individuals is to maximise their future payoffs from their relationship with the wrongdoer, they are expected to be indifferent to the way
the law treats the nonlegal sanctions they inflict to the wrongdoer. Thus, a deduction rule is expected to have little effect on the level of such nonlegal sanctions.

The general conclusion that needs to be drawn from this section is that when designing a legal policy with respect to nonlegal sanctions the law cannot treat nonlegal sanctions as a given. Legal sanctions and nonlegal sanctions are intra-related. The level of damages in general and the legal rules that treat nonlegal sanctions directly will affect the level of nonlegal sanctions.

III. NONLEGAL SANCTIONS AND DAMAGES - A NORMATIVE ANALYSIS

After understanding endogenous effects of deduction rules on the level of nonlegal sanctions we can turn to evaluate whether the adoption of such rules is desirable. The analysis in this section will first point out the advantages and disadvantages of legal and nonlegal sanctions. The analysis will then build on the framework introduced in Sections I and II in order to evaluate whether the adoption of a deduction rule is desirable with respect to each kind of nonlegal sanction.

1. Nonlegal Sanctions and Damages Compared

Before developing a policy, which deals with nonlegal sanctions and damages, we must first understand their relative advantages and disadvantages. Damages have

57 The law can raise the level of such nonlegal sanctions by lowering the costs of acquiring information as to the acts of wrongdoers. An example for such a policy are sex offender registration laws commonly known as Megan's Laws. For a comprehensive description of such laws see generally Alan R. Kabat, Note, Scarlett Letter, Sex Offender Databases and Community Notification: Sacrificing Personal Privacy For a Symbol's Sake, 35 AM. CRIM. L. REV. 333 (1998).
58 The argument in the text should be qualified in those cases in which the level of the legal sanction serves as a signal for the need to lower the demand for the services of the wrongdoer. In such cases the signaling effect of the level of the legal sanction will cause a reduction of the nonlegal sanction if a deduction rule will be adopted.
several characteristics that render them superior to nonlegal sanctions as a tool to create proper incentives. One such characteristic is the fact that damages are merely wealth transfers and, thus, they do not create a dead weight loss. Nonlegal sanctions on the other hand do include a dead weight loss element. For example, shaming might create a loss to the sanctioned party that is not necessarily offset by the benefit created to the person inflicting the nonlegal sanction.

A second advantage of damages is that they are a more controlled form of sanctioning. Damages allow a decision maker to decide on the precise size of the sanction. These decision makers can tailor efficient sanctions that are motivated by a rational analysis of what the optimal sanction should be. Nonlegal sanctions on the other hand are a far less controlled form of sanctioning since there is no central mechanism that determines their size. Rather, the creation of nonlegal sanctions depends on a cost benefit analysis performed by the individual applying them. This decision making process may cause nonlegal sanctions to obtain values that do not necessarily represent a socially desirable level of sanctioning.

A related problem of nonlegal sanctions is the fact that they generate additional uncertainty as to the expected magnitude of the sanction. Since the decision making process regarding the infliction of nonlegal sanctions is a decentralised one, nonlegal sanctions will tend to fluctuate. This additional uncertainty might deter risk averse individuals from engaging in beneficial activities. Damages on the other hand

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59 Cooter and Porat base much of their analysis on the important insight that nonlegal sanctions do not represent a complete dead weight loss. As pointed by Cooter and Porat in many cases the nonlegal sanctions create a social value (Cooter and Porat, supra note ______ at 405-6). Nevertheless nonlegal sanctions clearly cause a deadweight loss in at least some of the cases.

60 Posner, (THE ECONOMICS OF JUSTICE) supra note ___ at 215, (stating that a pure system of retaliation may result in the imposition of inefficient penalties); and Posner, (LAW AND LITERATURE) supra note ____ at 53-4 (presenting a cost–benefit analysis of the level of revenge parties will choose to inflict).
are relatively easy to estimate ex-ante. They are set within a framework of legal rules that determine their size, and are applied in a transparent way that allows parties to learn over time what can be expected from the legal system. Thus, legal sanctions help individuals engage in risky activities, allowing them to decide whether the potential sanction is worth the potential gains of the act.

Yet nonlegal sanctions do encompass some relative advantages when compared to damages. A first advantage that nonlegal sanctions hold in some cases is the relatively low cost of applying them. Damages are a costly sanction to administer due to the high costs of litigation. Since victims of wrongful acts file suits only if the expected value of the suit exceeds its cost,⁶¹ high litigation costs might cause some victims to forgo litigating over part of the harm caused to them that is costly to litigate, or even to forgo any litigation. Even efficient procedural mechanisms such as class actions remain costly and will often not justify the filing of legal suits from the perspective of victims. Nonlegal sanctions, on the other hand, are in many cases a relatively cheap sanctioning device. For example, the destruction of the reputation of a promisor that breached a contract can be done at a relatively low cost. Thus, parties might find such sanctions to be the most feasible way to sanction wrongdoers.⁶²

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⁶¹ The analysis in the text assumes that parties will choose not to bring suits with a negative present value. For a models in which parties do choose to bring such suits see, e.g., Lucian A. Bebchuk, *Suing Solely to Extract a Settlement Offer*, 17 J. LEGAL STUD. 437 (1988) (presenting a model of imperfect information); David Rosenberg & Steven Shavell, *A Model in which Suits are Brought for their Nuisance Value*, 5 INT’L REV. L. & ECON 3 (1985) (presenting a model in which defendants are willing to settle cases to avoid the cost of responding to the claim); and Lucian A. Bebchuk, *A new Theory Concerning the Credibility and Success of Threats to Sue*, 25 J. LEGAL STUD. 1 (1996) (presenting a model in which plaintiffs have credible threats to continue with their suits due to the fact that the cost of litigation is spread over time).

⁶² Furthermore, the analysis in the text has focused on the costs of legal sanctions that the litigating parties bear themselves. The operation of the legal system includes additional costs that are not born by the litigating parties but rather by society in large through the subsidization of the legal system. From this perspective it might be beneficial to encourage parties to create cheaper nonlegal systems that will substitute the legal system even if the parties themselves find the legal system to be a superior option.
A second relative advantage of nonlegal sanctions is the fact that they are not based on the concept of compensation. In bilateral care cases compensation prevents an efficient outcome because it erodes the incentives of victims to take the necessary precautions. In such cases in order to achieve efficiency a legal regime must include what Cooter refers to as double responsibility at the margin, meaning that each party must be fully responsible for the harm. Nonlegal sanctions can serve as a tool that helps achieve double responsibility at the margin since they deter potential wrongdoers while creating only small benefits for potential victims.

A final advantage of nonlegal sanctions is that they create an independent value. The utility gained by individuals who hold a personal preference for sanctioning, and the potential advantages of nonlegal sanctions as signaling devices, should be accounted for while developing a policy aimed at nonlegal sanctions. A

For an historical example of such policies see West, supra note at 2605-6 (suggesting that in the 18th century the Japanese government denied access to courts from future traders in the Dojima Rice Exchange in order to encourage them to create private ordering mechanisms and thus save public resources). Cooter and Porat have pointed out the connection between sustaining victim’s incentives and nonlegal sanctions (Cooter & Porat, supra note at 410-3). The focus of their discussion is the advantage of the deduction rule they propose in this regard.


In situations in which transaction costs are low parties could try to overcome the incentive problem described in the text by adopting contractual mechanisms that will involve compensating third parties rather than victims. For an introduction of such a concept see Robert Cooter & Ariel Porat, Anti-insurance, 31 J. Legal Stud. 203 (2002).

Utilitarian accounts of the social value of reciprocity go as far back as the writings of Bentham, who argued in his distinct way:

“…Every kind of satisfaction, as it is a punishment to the offender, naturally produces a pleasure of vengeance to the injured party. That pleasure is a gain; it calls to mind Samson’s riddle – it is the sweet coming out of the terrible, it is honey dropping from the lion’s mouth. Produced without expense, a clear gain resulting from an operation necessary on other accounts, it is an enjoyment to be cultivated, like any other; for the pleasure of vengeance, abstractly considered, is like every other pleasure, a good in itself”.

legal regime that will eliminate the social value of nonlegal sanctions without accounting for this value is not necessarily a socially optimal regime.

After understanding the potential endogenous effects of the law on nonlegal sanctions and some of the main advantages and disadvantages of nonlegal sanctions we can now turn to evaluate how should the law treat nonlegal sanctions. In the three following subsections I will examine the unique legal implications with respect to each kind of nonlegal sanctions, and will offer courts a conceptual framework in order to set damages at a socially optimal level.

2. Nonlegal Sanctions Driven by Personal Preferences

The argument presented in this subsection is that applying a deduction rule to preference driven nonlegal sanctions is undesirable in most cases. This argument is based both on the deterrence value of such nonlegal sanctions and on the fact that such nonlegal sanctions create an independent value that should be protected.

The reason preference driven nonlegal sanctions might be efficient from a deterrence perspective is that damages in many cases do not encompass the full social cost of the wrongful act. As we have seen operating the legal process in order to be awarded damages is costly, therefore damages will not reflect some of the harm caused by an act. This harm can be part of the harm caused to the party bringing a legal suit, and can also be harm caused to remote parties that will not bring any legal suit despite the fact that they were injured by the wrongful act.\textsuperscript{68} Preference driven

\textsuperscript{68} These remote parties might not bring suit because of the costs of litigation or because of explicit legal doctrines that limit their ability to file suits. An example of such limitations can be seen in the context of emotional distress. Courts have set strict standards for recovery for such harms using doctrines such as proximate cause (see Dillon v. Legg 441 P.2d 912 (Cal. 1968)). Though such
nonlegal sanctions can assist to fill this deterrence gap since they are driven – among other things - by harms unaccounted for by the legal system.\textsuperscript{69} Nonetheless it should be noticed that the level of the nonlegal sanction is not produced in a way that promises that it will be an optimal supplement to damages. Rather, the level of harm caused by the wrongful act that is not included in damages is merely correlated to the level of the nonlegal sanction. Factors such as the cost of inflicting nonlegal sanctions and the level of sanctions that individuals perceive to be appropriate will play a central role in determining the level of these nonlegal sanctions.

Furthermore, relying on nonlegal sanctions rather than on raising the benchmark legal sanction in order to capture harms that are not accounted for by the legal system, is beneficial from the perspective of sustaining victim incentives. If we were to raise the benchmark legal sanction awarded to victims who do find it economical to litigate by allowing them to collect damages for harms that are not accounted for by the legal process, the problem of the incentives of victims would worsen. Enlarged damages would not only erode the incentives of potential victims to take the required precautions, but would actually give individuals incentives to become “victims” in those cases in which the additional harm was inflicted to third

\textsuperscript{69} This characteristic depends on the fact that what the individuals perceive to be an appropriate sanction has some connection to harms that are not accounted for by the legal system.
parties. Nonlegal sanctions can help us avoid this moral hazard by sanctioning the wrongdoer without creating a substantial benefit to potential victims.70

Courts should take into account the analysis presented above while dealing with cases that involve nonlegal sanctions driven by preferences. If the court identifies the case as a case in which there are many damages that cannot be accounted for in litigation then as long as the nonlegal sanction is not excessive in the sense that its size is larger than the size of unaccounted for harm, the court should not deduct the nonlegal sanction. Such a policy has three benefits – it will sustain the utility gained by individuals from the act of inflicting the nonlegal sanction, it will bring the total sanction inflicted to wrongdoers closer to an optimal level, and it will achieve this goal without diminishing the incentives of victims to take care.

If on the other hand the court finds that the nonlegal sanction might be excessive, in the sense that it is larger than damages that are unaccounted for and creates an over-deterrence problem, the picture becomes more complicated. While from the perspective of the specific case at hand it might be beneficial to deduct the nonlegal sanction from damages, such a policy might trigger the different endogenous effects of a deduction rule described above. Without knowing the preferences of the sanctioning individuals and the specific costs of inflicting nonlegal sanctions courts will be unable to know how the deduction rate they set will actually affect the final total sanction wrongdoers face. For example, setting a low deduction rate might cause a very limited change in the total sanction if the substitution effect is high, while

70 An alternative mechanism aimed at raising the benchmark level of the legal sanction can be the introduction of fines that will equal the size of the harm not included within the damages awarded in a private suit. For a proposed legal regime in which fines act as supplements to liability see Shavell, supra note _____ at 233-5. Fines have the same positive quality that nonlegal sanctions have with respect to sustaining victims’ incentives to take optimal care since they do not compensate victims.
setting a high deduction rate might completely eliminate the use of nonlegal sanctions and cause a sharp fall in the total sanction.

Given the uncertainty created by the endogenous effects of deduction rules, and the fact that in many cases nonlegal sanctions can act as an efficient supplement to legal sanctions, the rule proposed here with regard to preference driven nonlegal sanctions is a selective deduction rule. Under such a rule courts will deduct nonlegal sanctions from damages only in unique cases in which the nonlegal sanction is clearly excessive. The advantage of such a rule is that it allows courts to tailor efficient combinations of legal and nonlegal sanctions while having a limited effect on the level of nonlegal sanctions. The reason a selective deduction rule will have such a limited effect lies in the fact that in many cases members of the sanctioning group decide whether to inflict the sanction individually, and only subsequently do they observe the decision of other members of the group. Thus, these individuals will find it difficult to know at the time they decide whether to inflict the nonlegal sanction whether the subsequent size of the nonlegal sanction will be sufficient to trigger a deduction, and the effect of the rule will be lower. Courts should also consider selectively deducting excessive nonlegal sanctions in cases in which the legal sanction is clearly not a substitute for nonlegal sanctions, and therefore will not affect their level. For example, cases of vengeful violence might create excessive sanctions and are not expected to diminish as a result of a deduction rule.

71 The selective deduction rule might cause some disutility to those individuals who sanctioned wrongdoers under the incorrect assumption that the nonlegal sanction they inflict will not be deducted. Courts should try to avoid such disutility if they can by minimising the publication of the fact that they applied the rule in a specific case, while continuing to inform potential wrongdoers of the existence of a deduction rule. If such a scheme will not be successful then such disutility should be accounted for when deciding whether to apply the rule.
One factor that might render the selective deduction rule undesirable is the cost of implementing it. Undoubtedly, a selective deduction rule could cause significant application costs since such a rule would require courts both to measure the level of the nonlegal sanction and to decide whether it should be deducted in a specific case. Thus, a rule that will be applied in a limited amount of cases will raise the costs of litigating many disputes in which defendants will argue that they were subjected to an “exceptionally” high nonlegal sanction. Nevertheless, clear judicial guidelines as to the size of the nonlegal sanction that is required in order to trigger an evaluation of the issue can limit this problem. The final answer as to the efficiency of such a rule is an empirical one and depends on the benefit from preventing over-deterrence and the additional litigation costs.

The example of sexual harassment presented by Cooter and Porat is an excellent platform in order to demonstrate the role of nonlegal sanctions as a deterrent for harms unaccounted for by legal sanctions. Sexual harassment does not involve only the (usually) male employer and the (usually) female employee that is harassed in a specific case. Rather, an act of sexual harassment harms women as a group since it reflects part of the gender-power structure of society. Yet the legal treatment of sexual harassment does not take into account such costs of sexual harassment, but rather views the issue as a dispute between the harasser and the direct victims of the harassment. Thus, although the law of sexual harassment has come a long way since the mid seventies when courts began recognising the damage caused by sexual

73 In the United States sexual harassment is generally governed by private enforcement alone. For an updated overview of sexual harassment law in the United States see, e.g., Francis Achampong, WORKPLACE SEXUAL HARASSMENT LAW (1999).
harassment, the legal doctrine still offers an extremely limited remedy to the problem. Even if we assume that the specific victim of the harassment was perfectly compensated for all the harms she has suffered, this will still not suffice in order to achieve optimal deterrence since not all of the damages inflicted by the act are internalised by the harasser. Hence, if for example the victim and some of her co-workers actively shame the harasser, such a supplemental nonlegal sanction could be desirable from a deterrence perspective. On the other hand it should be noted that this additional sanction should be capped, and that potential harassers should not face a potentially infinite sanction. The borderline between acts of harassment and desirable social interaction may not always be clear. An excessive sanction on sexual harassment might lead to inefficiently low level of social interaction. Thus, a selective deduction rule that will minimise this over-deterrence effect will allow for an efficient level of social interaction.

3. Nonlegal Sanctions Driven by the Anticipated Behavior of Others

From a deterrence perspective there is room for scepticism as to the ability of such sanctions to act as efficient supplements to legal sanctions given the unique social mechanism that underlies these sanctions. As we have seen, the forces driving the creation of these sanctions include unclear social phenomena such as focal points and sanctioning norms. As a result these sanctions will tend to emerge around specific

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75 Given the under-deterrence problem described in the text it could be desirable to criminalize some acts of sexual harassment in order to create optimal deterrence. Indeed in some jurisdictions sexual harassment law has adopted this line of thinking and uses criminal sanctions as supplements to damages. For an example of such a regime that was recently adopted in Israel see The Prevention of Sexual Harassment Law, 1998, S.H. 166.
76 *Cooter & Porat*, supra note ____ at 407 (suggesting that an excessive sanction for sexual harassment might over deter the socially beneficial act of flirting).
cases that manage to capture the public eye such as cases in which the wrongdoer is a
publicly known figure or cases that have some sort of factual “twist” that makes them
more interesting to the public and not around cases that suffer from a deterrence
deficiency. Furthermore, as we have seen the level of these nonlegal sanctions is not
determined even by what the sanctioning individuals perceive as an appropriate
sanction (not that that measure is necessarily efficient), but rather by the desire of
these individuals to avoid the consequences of not sanctioning. The analysis thus far
points towards the conclusion that courts should be more open towards adopting a
deduction rule with respect to nonlegal sanctions that are driven by anticipated
behavior of others. These sanctions have a potential of becoming excessive, and as we
have seen in the previous section the effects of such a deduction are expected to be
limited in comparison to preference driven nonlegal sanctions.

Yet just as was the case with respect to preference driven nonlegal sanctions
evaluating these sanctions requires taking into account the social benefits created by
the act of sanctioning. While nonlegal sanctions that are driven by an upper-norm of
sanctioning do not create an independent social value, signaling nonlegal sanctions do
create such a value. Signaling nonlegal sanctions deter wrongdoers only incidentally
to their primary goal, which is to signal the cooperative nature of the sanctioning
party. Even though the effect of a deduction rule on the use of nonlegal sanctions is
expected to be limited, it still might undermine the use of nonlegal sanctions as
signals. If in fact deduction rules do lead to such an unravelling of this signaling
device this lost benefit should be accounted for and might render the use of deduction
rules in this context undesirable. A potential solution to such a problem could be the
application of the selective deduction rule proposed above to these sanctions as well since such a rule is expected to have a smaller effect on nonlegal sanctions.

A view at the sexual harassment example may prove fruitful in this context as well. In some cases an act of sexual harassment may become the focal point for a nonlegal sanction. In such situations individuals in the workplace will choose to sanction the harasser not necessarily because they think sanctioning him is just, but rather because if they will not sanction him they will be perceived as non-co-operators that should be sanctioned. These situations can be identified by the nature of the sanction that will usually involve general participation in the act of sanctioning, and sanctions being applied to the defiant individuals that choose not to sanction. If for example all of the workers in a workplace force the termination of the harasser despite the fact that his position poses no risk of future harassments this might indicate such a nonlegal sanction.77

4. Nonlegal Sanctions Driven by Adjustment to New Information

Finally we turn to evaluate how should the law treat information driven nonlegal sanctions. As we have seen these sanctions are driven by the fact that new information will cause self-interest maximising individuals to adjust their attitude towards wrongdoers. The utility maximising nature of such decisions has normative implications since the new attitude of the sanctioning party towards the wrongdoer reflects the efficient attitude from a future looking perspective towards the wrongdoer.

77 A specific example for such behavior in the context of sex offenders can be found in the Amici Curiae brief filed on behalf of The New-Jersey Public Defender in Smith v. Doe 538 U.S. _____ (2003). This brief documents a case in which an employer was forced by the community to terminate a registered sex offender despite the fact that the employer thought that such a reaction was not necessary (Id. at 17-8; brief is on file with author).
Any reduction of the damages paid by wrongdoers as a result of the discovery that they are not what they have claimed to be would perpetuate for these individuals their welfare as “good” types while they are actually “bad” types. As a result wrongdoers will not internalise the full cost of their acts and optimal deterrence will not be achieved. The role of legal sanctions is to set optimal incentives for potential wrongdoers regarding the wrongful act according to the potential harm of the act. This role is completely separate from the forward-looking decision of individuals regarding how to continue to conduct their future business with the wrongdoer.

Furthermore, deducting the loss to wrongdoers from the revelation that they are bad types would give these individuals incentives to misrepresent their character. Once these bad types represent themselves as good types they will be assured that the drop in their welfare once they are discovered as bad types will be offset by the deduction rule. A deduction rule would grant in effect potential wrongdoers an “expectation interest” in the social status that they gained through a misrepresentation.

A further analysis of the sexual harassment case might prove fruitful in this context as well. One may assume that until an employee was sexually harassed by her boss she and her colleagues might have thought that the sexual harassing boss was a friendly gentleman. Thus, they were willing to be social with him, spend time with him when other people were not present and so on. Yet after the boss committed an act of sexual harassment the employee and her colleagues have gained more information about the boss and now they know that there is a high risk that he will
harass one of them again. As a result the employees will adjust their demand for social contact with the harasser in order to minimise their risk of being harassed.

This section has presented a nuanced analysis of the way the law should treat different kinds of nonlegal sanctions. The conclusion of the analysis was that applying deduction rules to nonlegal sanctions might be beneficial in some settings, yet if courts are to apply such rules they must first understand the specific forces driving the nonlegal sanctions that are at hand. As we have seen from the sexual harassment example presented in the text each setting may generate unique kinds of nonlegal sanctions that need to be well understood before they are dealt with. In the next section I turn to deal with one specific setting of nonlegal sanctions that has several unique characteristics – the setting of commercial transaction.

IV. NONLEGAL SANCTIONS IN THE COMMERCIAL CONTEXT

I now wish to turn to examine the connection between damages awarded by the courts and nonlegal sanctions, in the specific context of commercial transactions. The analysis will follow the footsteps set out in the previous sections of this article. I will begin by evaluating what are the forces underlining the creation of nonlegal sanctions in this context. Once a plausible answer will be presented I will turn to

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78 For an introduction of a scale measuring the likelihood of individuals to sexually harass others see John B. Pryor, Sexual Harassment Proclivities in Men, 17 SEX ROLES (1987) 269. See also John B. Pryor & Lynnette M. Stoller, Sexual Cognition and the Processes in Men High in the Likelihood to Sexually Harass, 20 PERSONALITY AND SOCIAL PSYCHOLOGY BULLETIN (1994) 163 (supporting the hypothesis that individuals in a high likelihood to sexually harass perceive a connection between sexuality and social dominance); and John B. Pryor, Christine M Lavite & Lynnette M. Stoller, A Social Psychological Analysis of Sexual Harassment: The Person Situation Interaction, 43 J. OF VOCATIONAL BEHAVIOR 68 (1993) (Analysing the personal characteristics that effect the likelihood of individuals to sexually harass).
evaluate the possible endogenous effects of the law on nonlegal sanctions in this context, and finally, I shall suggest how should courts set damages this context.

1. Reputation as a Contract Remedy

It does not require extensive empirical research of the business world to notice that parties to commercial transactions choose to invest in nonlegal sanctions that are inflicted upon them if they breach contracts. More specifically I am referring to the choice of parties to invest resources into the development of a reputation, an investment that is expected to increase the potential nonlegal sanction. Examples of such investments are expenditures made on advertising, the development of trademarks, and setting up operations in luxurious offices.

An extensive line of economic literature has been devoted to modelling the economic role of reputation in commercial transactions. The general role of reputation in these models is to assure buyers of the quality of the products or services they are buying in a world of asymmetric information regarding quality levels. The implicit assumption of these models is that buyers are not protected by a costless legal remedy that will compensate them in case the seller misrepresents the quality of the

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79 The landmark study of the use of such mechanisms in business relations is Stewart Macaulay, Non-contractual Relationships in Business: A Preliminary Study, 28 AM. SOC. REV. 55 (1963). For more contemporary studies of the issue see: Bernstein, Cotton Industry, supra note ______.
80 See, e.g., Benjamin Klein & Keith B. Leffler, The Role of Market Forces in Assuring Contractual Performance, 89 J. POLITICAL ECON. 615, 625-633 (1981) (presenting a model in which firm specific capital investments help producers to commit to high quality); Lewis A. Kornhauser, Reliance, Reputation, and Breach of Contract, 26 J. L. & ECON. 691, 695-702 (1983) (presenting a model in which reputation acts as a substitute for legal damages); and Carl Shapiro, Premiums of High Quality Products as Returns to Reputations, 98 Q. J. ECON 659, 662-673 (1983) (describing an equilibrium in which consumers pay information premiums for products with a good reputation in order to assure the quality of the products that they purchase).
goods or the services. Thus, in these models reputation serves as a substitute to legal sanctions given the specific drawbacks of legal sanctions.

There are several reasons to assume that the legal remedy for breach of contract, namely expectations damages, has several drawbacks that will drive specific contracting parties to use reputation both as a substitute and a compliment to it. First, one should notice that while expectations damages are the optimal remedy from the perspective of giving the parties efficient incentives to perform,\(^8^1\) there are other perspectives of the contractual relationships in which the expectation measure is inferior to other remedies. For example issues such as the parties’ attitudes towards risk,\(^8^2\) reliance decisions,\(^8^3\) and ability to invest before contracting in acquiring information,\(^8^4\) can all render the expectation measure of damages to be a sub-optimal measure for specific contracting parties. The fact that expectation damages might be the efficient majoritarian default remedy says nothing as to what is the optimal remedy for a specific set of contracting parties.

Second, even if the expectation measure is the optimal measure of damages for the specific contracting parties, it is quite clear that the legal system does not offer contracting parties a true expectations remedy. Problems such as litigation costs,\(^8^5\) the

\(^{8^1}\) See: Shavell, *Damage Measures*, *supra* note __; and Shavell, *Design of Contracts and Remedies*, *supra* note ____.

\(^{8^2}\) A. Mitchell Polinsky, *Risk Sharing Through Breach of Contracts Remedies*, 12 J. LEGAL STUD. 427, 433-4 (1983) (noting that the expectation remedy would be optimal from the perspective of the allocation of risk only if the buyer is risk averse and the seller is risk neutral).

\(^{8^3}\) Cooter (unity) *supra* note _____ at 11-9.

\(^{8^4}\) Carswell, *supra* note ____ at 425-6 (pointing out that in some cases damages larger than the expectation measure are required to induce optimal precontractual investigations).

\(^{8^5}\) The costs of litigation would be especially influential in jurisdictions by the American rule under which legal costs are not shifted to the losing party. There are alternative legal regimes regarding litigation costs, namely the English rule under which legal costs are shifted to the losing party. See generally Steven Shavell, *Suit Settlement and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs*, 11 J. LEGAL STUD. 55 (1982).
existence of a secrecy interest, the expected length of legal procedures, or the existence of a specific idiosyncratic value that is not accounted for by courts, can all render the legal remedy for breach of contract to be smaller than the actual expectation interest of the promisee. The difference between the expectation interest of the promisee and the net legal sanction is a continuum that depends on the specific circumstances of every contract. In some cases the legal system offers a remedy that although not perfect is relatively close to the expectation interest of the promisee, while in other cases the legal system offers a remedy that is substantially lower than the expectation interest of the promisee, and yet in other cases the legal system is simply not a practical way to enforce the rights of contracting parties.

By this point it should be clear why contracting parties would have a preference for nonlegal sanctions. Nonlegal sanctions can serve as a solution to the shortcomings of legal remedies for breach of contract. Parties facing insufficient legal remedies will be able to enhance their mutual payoffs from contracting by agreeing on additional (and costly) sanctions as long as the benefits of creating optimal incentives outweigh the cost of the additional sanctions.

86 For an analysis of the secrecy interest of contracting parties see Omri Ben Shahar and Lisa Bernstein, *The Secrecy Interest in Contract Law*, 109 YALE L. J. 1885 (2000). A specific case of the secrecy interest and the role of nonlegal sanction as a method of overcoming the problem of inability to sue due to a large secrecy interest can be found in the context of the cotton industry. See Bernstein, *Cotton Industry*, supra note ______ at 1756-59.
87 Dennis E. Garrett, *supra* note ______ at 19 (pointing out that consumer boycotts can expedite change given the possibility of delay tactics in legal suits).
88 This could be due to explicit doctrinal reasons such as limitations on compensation for emotional disturbance (*see* Restatement (Second) of Contracts §353 (1981)), and due to problems in proving some kinds of damages at trial (*see* Goetz and Scott, *supra* note ______ at 568-577).
89 By using the term net legal sanction I am referring to the legal sanction minus all of the costs associated with it.
90 This intuitive point has been shown to hold in experimental studies of contracting behavior, see Ernst Fher, Simon Gächter & Georg Kirchsteiger, *Reciprocity as a Contract Enforcement Device: Experimental Evidence*, 65 ECONOMETRICA 833 (1997). In this study participants simulated parties negotiating an employment contract in which the employers had to decide on the wages of the
A specific example of an extra-legal remedy that parties might choose to use is bonds. A distinction should be drawn between bonding and signaling equilibrium. The difference between the two lies on the fact that signaling equilibrium deals with the ex-ante disclosure of the characteristics of a party, while bonding refers to altering the incentives of a party at the ex-post stage. See Sanford J. Grossman and Oliver D. Hart, Corporate Financial Structure and Managerial Incentives, in THE ECONOMICS OF INFORMATION AND UNCERTAINTY 107, 109-10 (John J. McCall ed., 1982). Consistent with this terminology sanctions based on reputation should be viewed as a bonding mechanism.

Reputation has several advantages as a bonding asset. On one hand, a reputation can be an extremely important asset from the viewpoint of the promisor. Hence, a reputational bond will create a high incentive for the promisor not to defect. On the other hand, the destruction of the promisor’s reputation creates little...
if no monetary value for the promisee. Generally, bonds that have little value for the party holding them are superior since they prevent opportunistic behavior on behalf of the party holding the bond that might occur if foreclosure were profitable.

In sum, contracting parties are expected to have a preference for creating nonlegal sanctions given the characteristics of the legal sanction offered to them by the courts. Furthermore, since contracting parties are connected through a price nexus the pricing mechanism promises that the parties will select a level of nonlegal sanctions that will maximise the value of the contract. A promisee entering a contract with a “high” reputation promisor, a promisor that “has his reputation on the line”, will agree to pay a higher price for the contract that reflects the promisor's reputation. On the other hand, a promisee entering a contract with a “low” reputation promisor, a promisor that “has nothing to lose”, will agree ex-ante to a nonlegal sanction.

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95 The payoff structure of the threat to tarnish a promisor's reputation raises the question whether such a threat shall be viewed as a credible threat from the viewpoint of the promisor. Since the act of tarnishing a reputation comes at a cost to the promisee while not creating any monetary payoff the contracting parties will be facing a game identical to an ultimatum game. Several answers can be offered to the question why the threat to tarnish the promisor’s reputation is nevertheless a credible one. First, just as the reported data from ultimatum games indicates, promisees might have a preference for sanctioning. This preference changes the payoff structure of the game and creates a positive payoff for tarnishing a reputation. Promisors knowing ex-ante that promisees derive pleasure out of sanctioning them will view the threat of the sanction as a credible threat. Second, in the situation in which the nonlegal sanction is a by-product of the legal sanction promisees are expected to receive a monetary payoff for inflicting the nonlegal sanction in the form of damages. Finally, promisees might wish to impose nonlegal sanctions in order to create for themselves a reputation of tough business partners that sanction if not treated properly. For an economic model in which firms apply sanctions in order to create a reputation see Paul Milgrom & John Roberts, Predation, Reputation, and Entry Deterrence, 27 J. ECON. THEORY 280 (1982) (presenting a model in which an incumbent firm is willing to sacrifice resources preying on new entrants to the market in order to create for itself a reputation of a predator); and David M. Kreps, A COURSE IN MICROECONOMIC THEORY, 536-43 (1990) (presenting a model in which players wish to create a reputation of being “irrational” in order to maximize their long-run profits). See also Bernstein, Merchant Law, supra note _____ at 1796-7 (arguing that parties might choose to play end game strategies in cases of conflict in order to maintain the credibility of their threats). Yet it should be noticed that a party that will create such a reputation for himself will have to pay a premium at the time of future contracting since parties will perceive him to be a costly business partner (see Bernstein, Cotton Industry, supra note _____ at 1783-4 note 226).


97 For economic models connecting between reputation and higher product prices see, e.g., Klein & Leffler supra note _____; and Shapiro supra note ____.
lower contractual price. One can expect that over time different players will enter the market offering different levels of reputations according to the demand for reputation.98 In such a market promisees are free to choose to purchase from a promisor that offers them the optimal mix of legal and nonlegal sanctions.99

A second explanation for the use of reputational nonlegal sanctions aside from the preference to tailor optimal contract remedies is that the use of such sanctions can serve as signaling device. The application of a signaling model in this context is slightly different from the signaling model of nonlegal sanctions presented above in the general analysis of nonlegal sanctions. In the context of contracting parties the signal associated with the nonlegal sanction is not the act of sanctioning, but rather it is the willingness of the promisor to be subjected to the sanction of losing his reputation. In a signaling model of contracting for sanctions the size of the sanction a party agrees to can be used as a signal of his type.100 Good promisors, promisors with whom contracting is expected to have a higher payoff, will agree to a high sanction, while bad promisors, promisors with a low expected payoff, will only agree to a low sanction. Once a party agrees to be subjected to a high sanction it is communicating in a credible way that contracting with it is expected to have a high payoff since only good promisors can afford to send such a signal. Furthermore, it should be noted that in a signaling model promisors might agree to stipulate a

98 Shapiro, id. at 667 (describing an equilibrium in which a range of qualities will be sold in the market according to the preferences of consumers).
99 Kornhauser, supra note ____ at 703 (suggesting that in an imperfect world reputation can serve as a partial substitute for legal sanctions). For a specific example of a sophisticated combination of monetary and reputational sanctions see Bernstein, Cotton Industry, supra note ______ at 1754-62 (analysing the advantages of the hybrid monetary and nonlegal sanction regime in the cotton industry).
sanction that is beyond the expectation interest of the promisee since the goal underlining the sanction is to differentiate themselves from others.\textsuperscript{101}

Finally, just as it was in the general case, nonlegal sanctions in the commercial context may also be driven by adjustment to new information. An act of breach may reveal the true type of the promisor,\textsuperscript{102} causing potential promisees to adjust their demand for contracting with him.\textsuperscript{103} The analysis presented with respect to such nonlegal sanctions in the general sections of this article applies to this category as well, and repeating it would be redundant.

\section*{2. The Endogenous Effects of the Law on Reputational Bonds}

After understanding the function of reputational bonds it is now possible to evaluate the potential endogenous effects of a deduction rule on the use of reputation as a contractual remedy. In the context of commercial transactions it can be expected that the contracting parties will have a preference to sustain a total sanction that maximises the contractual surplus. In other words, it can be expected that in this context the predominate effect of the law on the level of nonlegal sanctions will be the substitution effect.\textsuperscript{104} This substitution effect will be constrained by the cost of

\textsuperscript{101} Aghion & Hermalin, \textit{supra} note \_, note 11 at 401.

\textsuperscript{102} The type of the promisor in this context can be easily interpreted in terms of probability of breach.

\textsuperscript{103} There are a few other forces that drive parties to invest in their reputation that are not referred to in the text. Such forces include – among other things - the need to convey information to consumers, a desire to effect consumer preferences (\textit{see} Avinash Dixit and Victor Norman, \textit{Advertising and Welfare}, \textbf{9} BELL J. ECON. 1 (1978)), and attempts to create market power (William S. Comanor \& Thomas A. Wilson, \textit{Advertising and Market Power}, 22-63 (1974)). Thus, from this perspective one may expect there to be a higher level of reputation developed then was to be expected from a purely sanction based analysis.

\textsuperscript{104} There are other factors that will affect the optimal selection of the level of nonlegal sanctions by contracting parties. On one hand, nonlegal sanctions reflect a deadweight loss from the perspective of the parties and therefore might not be wanted even if they create optimal performance incentives. On the other hand, nonlegal sanctions create superior reliance incentives on behalf of promisees and therefore will enhance the contractual surplus from this perspective.
creating additional nonlegal sanctions, since parties will invest in nonlegal sanctions only as long as the marginal benefit created by them in the form of proper incentives exceeds the marginal costs of creating them, and by the fact that parties may always choose to set the nonlegal sanction at zero and avoid any deduction (and any cost of inflicting nonlegal sanctions). The final outcome contracting parties will choose depends on the importance of creating sufficient incentives for the parties and on the costs of creating additional nonlegal sanctions.

3. Reputational Bonds and the Law – A Normative Analysis

The proposition brought forward in this subsection is that the price nexus that exists between contracting parties assures that reputational bonds will be tailored in such a way that the level of the legal and the nonlegal sanctions will be close to the optimal sanction from the parties’ perspective. The reason for this is that the parties have a common interest to design contract remedies that will maximise the value of their contract. Viewed from this perspective, nonlegal sanctions should be treated as an additional remedy that the parties agreed on at the time of contracting. Thus, as long as we find the contract between the parties to be to be enforceable we should also respect the nonlegal sanctions that the parties agreed upon.105

Nevertheless even if reputational nonlegal sanctions are tailored by the parties ex-ante there might still exist reasons for ex-post intervention in the form of a deduction rule that should be ruled out. The first such reason is that due to their elusive nature nonlegal sanctions are difficult to predict ex-ante. Even the most

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105 For a similar claim with respect to liquidated damages see Goetz & Scott, supra note ____ at 587 (stating that "the very existence of a freely negotiated agreed damages provision is compelling presumptive evidence that it constitutes the cost-minimizing alternative").
sophisticated and well-informed contracting parties might find it difficult to structure nonlegal sanctions that will be perfectly aligned with the legal sanction to create an optimal sanction. Given this unpredictability one might argue that contracting parties would have wanted to contract ex-ante for a rule similar to the selective deduction rule introduced above under which nonlegal sanctions will be deducted from damages in cases of pathologically high nonlegal sanctions that are well beyond the expectations of the parties.

Yet it would seem that the costs of implementing a selective deduction rule in the contractual setting outweigh the potential benefits. Opening the question of the level of nonlegal sanctions to ex-post litigation will require parties in almost any case in which a nonlegal sanction exists to litigate an issue that will justify a reduction in the legal sanction in only a handful of cases. Of course this argument could be made as to the application of the selective deduction rule in all cases. Yet the case of nonlegal sanctions in the contractual context is unique since in this setting – unlike in other settings - it is the parties themselves who choose the level of the nonlegal sanction. From this perspective nonlegal sanctions are similar to any other legal mechanism that assigns risks ex-ante. If we cannot point out a systematic pathology in the decision making process of creating reputational bonds, there is no reason to assume that on average these sanctions are tilted one way or the other. Furthermore, as we have seen contracting parties turn to nonlegal sanctions because of the inability of the legal system to provide them with an optimal remedy. If we were to allow an ex-post evaluation of the level of the nonlegal sanction this evaluation would have to account for all of the factors that affect the design of the optimal remedy for the
specific contracting parties. Thus, courts would have to take into account the full subjective expectation interest of the promisee, the parties relative risk averseness, the parties reliance decisions and the other factors that might affect the design of the optimal remedy in order to evaluate if the nonlegal sanction is in fact excessive. One might be sceptical as to the ability of courts to succeed in such an evaluation.

A second reason that might be proposed for the adoption of a deduction rule in the context of commercial transactions is that if nonlegal sanctions are in fact used as signals, limiting the parties ability to agree to high sanctions might be in their best interest since such limitations might prevent them from wasting resources on ineffective signaling. Using this line of reasoning it has been argued that the penalty doctrine, which is employed by the common law in order to limit the ability of parties to stipulate damages, might be efficient.

Nevertheless there are several reason to be sceptical whether this justification for the penalty doctrine is applicable to nonlegal sanctions. First, it should be noted that the signaling model itself does not always lead to the conclusion that a limitation on the level of sanctions parties can inflict to themselves is efficient. For example, in cases in which the initial equilibrium is a separating equilibrium in which good promisors and bad promisors agree to different liquidated damages, limiting the

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106 According to Aghion and Hermalim supra note contracting parties might fail to achieve a separating equilibrium through the use of sanctions they agree to be subjected to when bad promisors attempt to mimic the contracts that good promisors offer in order to collect a higher payoff. In such cases good promisors will be driven to send increasingly higher signals to break away from the bad promisors. Yet when the differences between good and bad promisors are small these efforts will be in vain and the bad promisors will be able to afford to mimic the signal. Nevertheless in these situations the good (and bad) promisors will continue to send these useless signals since if they do not do so they will be perceived as bad promisors. Thus, the parties will reach an inefficient pooling equilibrium in which all promisors send useless and costly signals.

107 See RESTATEMENT (SECOND) OF CONTRACTS §356 (1981) (stating that “[d]amages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss”).

108 Aghion and Hermalim supra note _____.
ability of promisors to send signals might prove to be inefficient, since it might drive the parties into a pooling equilibrium.

Furthermore, there are differences between nonlegal sanctions and liquidated damages that may justify a distinction between the two. One such difference is the fact that unlike liquidated damages reputational bonds can be used with little or no help from the subsidized court system. This difference is of significance because the use of liquidated damages clauses as a signaling device might raise the amount of contract litigation. This claim might seem unlikely considering the fact that high liquidated damages increase the deterrence against breach and are expected generally to lower the number of cases of breach. Nevertheless there are two reasons to assume that the number of breaches might still rise due to the use of liquidated damages as signals. First, liquidated damages are actually a poor signaling device since they do not require any actual expense at the time of contracting. Thus, they enable parties that are at a high risk of default, and that would have normally found it difficult to contract, to attract contracting parties through the promise of liquidated damages. Reputational bonds on the other hand do not suffer from this drawback. A party wishing to attract contracting parties using a reputational bond must actually bear the cost of creating the bond before the creation of the contractual obligation. A second reason to assume that liquidated damages might cause a rise in contract litigation is that if liquidated damages are set at a supra-compensatory level in order to function as signals, they might encourage promisees to act in a non-cooperative fashion in an

109 Id. at 395-8.
110 Posner (Econ Analysis), supra note ______, at 143.
111 Id.
attempt to extract a breach. Reputational bonds on the other hand create no value to promisees, and thus there is a lower risk of opportunistic breaches.

Another difference between liquidated damages and reputational bonds that should affect the legal policy towards them is the fact that the regulation of reputational bonds is expected to be less effective than the regulation of liquidated damages. Liquidated damages are part of the legal sanction and depend on court enforcement. Hence parties will find it difficult to circumvent legal regulation. Reputational bonds on the other hand are created by the parties at a distance from the eyes of the courts. Hence, although a deduction rule will limit the parties’ ability to use some reputational bonds, parties will be able to develop alternative reputational bonds that will be more difficult for courts to detect and therefore will not be deducted. Contract design entrepreneurs will have incentives to develop such reputational bonds since they will allow them to signal in a credible way their type where such a signal was previously impossible. Eventually we will end up with a more costly separating equilibrium since it will be subject to the constraint of the deduction rule.

A general conclusion that should be drawn from this analysis of liquidated damages and reputational bonds is that, as a matter of observed behavior, contracting parties want to create mechanisms that offer more severe remedies than the legal

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112 Keneth W. Clarkson, Roger LeRoy Miller & Timothy J. Muris, *Liquidated Damages v. Penalties: Sense or Nonsense*, 1978 Wis. L. Rev. 351, 366-78 (1978) (arguing for legal limitations on liquidated damages when there is a risk that these clauses will cause promisees to induce breach). Yet the argument presented by Clarkson, Miller and Muris seems to carry little weight on its own. Informed parties are well aware of the moral hazard problem associated with liquidated damages and thus can be expected to deal with it effectively ex-ante. If however the moral hazard associated with liquidated damages creates an externality in the form of additional contract litigation this externality - rather than a concern for the welfare of the parties - may justify legal intervention.
Parties knowingly contract with parties that have a reputation and knowingly sign liquidated damages clauses that offer higher damages than can be expected at trial. These mechanisms come at a cost to promisees. Promisees pay a premium when contracting with high reputation parties or when demanding to stipulate high liquidated damages. Generally, parties pay these premiums because they find it to be beneficial after taking into account the drawbacks of the legal system. It is true that in some cases, such as those identified in the signaling model of liquidated damages, the parties might drive themselves to inefficient levels of sanctions. If such cases can be identified at a relatively low cost the law should deal with them and prevent them. Yet as a general conclusion it would be difficult to claim that parties have a constant tendency to agree to inefficiently high sanctions.

4. A Model

More formally the argument presented in this section can be depicted by the following model. In this model timing is structured such that courts move first and set the level of the baseline legal sanction and the deduction rate. Following this decision the contracting parties move and set the level of the nonlegal sanction. Finally courts set the legal sanction according to the pre-determined policies.

Denote:

\[ W(S) \] – The contractual surplus as a function of the total sanction promisees face in the case of breach.\(^{114}\)

\(^{113}\) Mann, supra note ______, at 2236-7 (discussing the connection between legal regulation of liquidated damages and the use of contractual mechanisms such as reputational bonds that are beyond legal regulation).

\(^{114}\) This function reflects the changes in the contract surplus as a function of the total sanction and does not capture the fact the shifting from legal to nonlegal sanctions creates a dead weight loss and affects the incentives of promisees to rely efficiently.
Given the application a deduction rule the following equality holds:

(1) \[ S_t = S_{L} - \alpha S_{NL} + S_{NL} \]

Which can be written as:

(2) \[ S_{NL} = (S_{t} - S_{L})/1 - \alpha \]

Contracting parties wish to maximize the value of their contract given the cost of inflicting supplemental sanctions. Yet this decision is subject to the constraint that the parties will not choose to create a costly supplemental sanction if they can achieve a larger surplus by setting the supplemental sanction at zero. Thus, the parties problem can be stated as:

(3) \[ \text{Max: } W(S_{t}) - c(S_{t} - S_{L})/1 - \alpha \]

s.t. \[ W(S_{t}) - c(S_{t} - S_{L})/1 - \alpha > W(S_{c}) \]

which generates the first order condition:

(4) \[ W'(S_{t}) = c'(\cdot)/1 - \alpha \Rightarrow S_{t} = \hat{S} \]
Equation (4) reflects the fact that parties will choose to apply a supplemental sanction up to the point in which the marginal benefit from sanctioning equals the marginal cost of sanctioning. Furthermore, this equation demonstrates why the adoption of a deduction rule is not desirable in the contractual setting. First note that parties will choose to inflict nonlegal sanctions only if \( S_L < S^* \). Therefore deduction rules will become relevant only in those cases in which the legal sanction is below the optimal sanction. Yet as we can see the affect of applying a deduction rule will only be to aggravate this problem since as the level of \( \alpha \) rises the level of the nonlegal sanction falls. This is caused by the fact that an increased \( \alpha \) raises the marginal costs of inflicting supplemental sanctions through the nonlegal channel.

**Conclusion**

This article has attempted to deal with the question of whether courts that aim to maximise social welfare should deduct nonlegal sanctions from damages. The analysis of this question rested on two insights that were presented in this article. The first is that without understanding the social forces driving the creation of nonlegal
sanctions it is impossible to develop a normative theory of how they should be treated. The second is that nonlegal sanctions are related to legal sanctions and thus when the law regulates nonlegal sanctions through a deduction rule it will inevitably affect the level of nonlegal sanctions. At the end of the day my answer to the question whether nonlegal sanctions should be deducted from damages is that for the most part such a deduction is not desirable. Nevertheless my analysis did point out that in some unique cases in which nonlegal sanctions might reach excessive levels it might be beneficial to adopt a selective deduction rule in order to create a more rational sanctioning regime. The reason that it is not certain that even this minimal rule should be adopted lies on the fact that the administrative costs of applying it might not justify its potential benefits.

The conclusion of this article is tentative in nature for the simple reason that there is very limited empirical data on the question of the endogenous effects of the law on nonlegal sanctions. Thus, this article should not be viewed as an article that aims towards sealing the debate over the design of optimal remedies in a world with nonlegal sanctions, but rather as an article that opens a discussion on this subject. Only after the relevant empirical work will be done in different social settings can this debate be concluded.

A final note should be made as to the issue of victim compensation. The selective deduction rule proposed here might be criticized on the ground that such a rule is unfair since it undermines the compensation of victims. Furthermore, it could be argued that as a positive matter the concern for compensation can explain the current structure of the law in which only non-compensatory legal sanctions, such as
criminal sanctions and punitive damages,\textsuperscript{115} are adjusted to supplemental sanctions. Not withstanding this positive observation, three normative comments should be made with respect to this expected criticism:

First, the assumption that it is the role of the law to supply victims with perfect compensation is problematic in a world in which potential victims have more efficient means of compensation, namely the insurance industry.\textsuperscript{116} The law should focus on what it can do well which is to create optimal incentives for parties rather than assure compensation.

Second, as we have seen perfect compensation creates a moral hazard for potential victims and it is unclear why preventing such behavior should be considered “unfair”. Stated differently, one might argue that it is unfair to impose on injurers to pay for damages that could have been prevented if victims would not have been oblivious to the liability of injurers.

And finally, even if we hold the belief that victims should be perfectly compensated that cannot be the end of the analysis. Any discussion of public policy issues such as the one presented in this article should include an element of a cost benefit analysis of the implications of the proposed policy. Ruling out a certain policy simply because it is “unfair” or “unjust” without evaluating the costs of such a decision is not a way in which a modern government can function. At the end of the day, a decision maker might decide not to adopt an efficient policy due to fairness considerations, yet this decision should only be reached after a rational discussion in

\textsuperscript{115} See supra notes _______ and accompanying text.

\textsuperscript{116} See, e.g., John J. Donohue, The Law and Economics of Tort Law: The Profound Revolution, 102 HARV. L. REV. 1047, 1047-49 (1989) (pointing out data that suggests that while the insurance industry provides victims with 80 cents of compensation for each dollar of cost the tort system provides victims with less than 50 cents of compensation on the dollar).
which the costs of the decision were fully understood. Viewed from this perspective this article took on itself to present a cost benefit analysis of deduction rules.