

Baby Steps

California Supreme Court Cautiously Ventures Into Federal Punitive Damages Law

By Curt Cutting

Without question, the due process limits on punitive damages have been one of the most hotly contested areas of civil litigation in recent years, but over the course of the last decade the California Supreme Court has mostly been content to stand on the sidelines.

It has been nine years since the U.S. Supreme Court decided the landmark case of *BMW of North America v. Gore* (1996) 517 U.S. 559 (*BMW*), which held for the first time that the Due Process Clause restricts the amount of punitive damages that can be awarded in a particular case. The U.S. Supreme Court addressed punitive damages again in 2001, deciding in *Cooper Industries v. Leatherman Tool Group* (2001) 532 U.S. 424 (*Cooper*) that appellate courts should apply a de novo standard of review when reviewing a district court's application of the *BMW* standards. And the court revisited these issues again in 2004, when it clarified and refined the *BMW* standards in *State Farm Mut. Auto Ins. Co. v. Campbell* (2003) 538 U.S. 408 (*State Farm*).

In the wake of these decisions, many state supreme courts issued opinions interpreting the Supreme Court's pronouncements. But until recently, the California Supreme court repeatedly declined to grant review in any cases dealing with excessive punitive damages.

Last year, the California Supreme Court decided to step into the fray. In March, the court granted review in *Simon v.*

San Paolo U.S. Holding Co., Inc. and *Johnson v. Ford Motor Co.*, two cases raising questions about how California appellate courts should apply the standards established by the U.S. Supreme Court. The California Supreme Court processed the cases together, moving them quickly through its internal case preparation process and holding a joint oral argument session before a packed courtroom on April 7, 2005. On June 16 the Supreme Court issued its opinions.

The opinions reveal a deliberately cautious approach by the court. They address only federal due process issues, and expressly decline to reach any issues arising under California punitive damages law. And even with respect to federal law, the opinions have a narrow scope. They shoot down a few arguments that the plaintiffs' bar has aggressively pursued to justify mega-awards, but they leave many issues unresolved and they contain some language that will make life more difficult for defense counsel.

Simon v. San Paolo U.S. Holding Co., Inc.

Simon involved a dispute over an agreement to purchase real property. Lionel Simon (plaintiff) had signed a letter of intent to purchase real property from San Paolo U.S. Holding Co. (defendant), and San Paolo agreed not to negotiate with any other prospective buyers while negotiating with Simon. San Paolo eventually broke this agreement and worked out a deal with another buyer. It then manufactured

a bogus reason for terminating negotiations with Simon. In Simon's lawsuit against San Paolo, the jury found there was no enforceable contract between the parties but that San Paolo was guilty of promissory fraud. The jury awarded \$5,000 in compensatory damages (representing the plaintiff's out of pocket expenses) and \$1.7 million in punitive damages.

San Paolo appealed, beginning a long and tortured appellate process. First, the Court of Appeal affirmed the award in an unpublished opinion. The California Supreme Court denied review, but the U.S. Supreme Court granted certiorari, vacated the decision, and remanded the case to the state court for reconsideration in light of *Cooper*. On remand, the Court of Appeal again affirmed the awards, the California Supreme court again denied review, and the U.S. Supreme Court again granted certiorari and remanded the case for further consideration, this time in light of *State Farm*. On remand, the Court of Appeal affirmed for a third time.

In a published opinion (the first one in the case), the Court of Appeal found that the amount of punitive damages did not violate due process because (1) San Paolo demonstrated extreme reprehensibility by engaging in intentional and repeated fraudulent acts, and (2) although the compensatory award was only \$5,000, Simon suffered actual harm in the amount of \$400,000, reducing the ratio of punitive to actual damages to 4:1. The court presumed that the jury's punitive damages award was implicitly based on Simon's claim that he expected to make \$400,000 when he resold the property. The court also concluded that the standard of appellate review required the court to defer to the jury's implicit factual finding.

The Supreme Court Opinion

The California Supreme Court reversed in a unanimous opinion authored by Justice Werdegar, reducing the \$1.7 million punitive damages award to \$50,000. (*Simon v. San Paolo U.S. Holding Co., Inc.* (June 16, 2005, S121933) ___ Cal.4th ___ [2005 WL 1404425] (*Simon*).)

The court first held that it was error for the Court of Appeal to defer to the jury's "implicit" finding that the plaintiff suffered \$400,000 in actual harm. The court reasoned that appellate courts should defer only to express findings of the jury, and should not infer that the jury made any other findings in the course of its deliberations. Instead, reviewing courts should review the record and make their own independent assessments of factual issues not resolved by the jury. The court then determined that the record did not support Simon's claim of \$400,000 in actual harm.

The court left the door open, however, for plaintiffs in future cases to justify punitive damages based on actual or potential harm not reflected in the compensatory damages award. The court took pains to explain that federal constitutional law "appear[s] to contemplate, in some circumstances, the use of measures of harm beyond the compensatory damages." (2005 WL 1404425, at p. *6.) In particular, the court noted that it is not unconstitutional for an appellate court to measure a punitive damages award against a plaintiff's actual but uncompensated losses in circumstances where "a statute barred recovery of damages actually caused by the defendant's tortious acts." (*Id.* at p. *8.) The court did place some limits, however, on the use of "potential harm" to justify a punitive damages award. The court noted that such harm must have been foreseeable by the defendant, and must have been likely to occur.

After considering this threshold issue, the court proceeded to analyze the reprehensibility of the defendant's conduct. The court noted that although the defendant's conduct involved intentional deceit, all other factors weighed against a high award: (1) the conduct caused only economic harm; (2) the defendant did not show disregard of others' health or safety; (3) the plaintiff was not financially vulnerable, despite having fewer resources than the defendant; and (4) even though the evidence showed deceptive conduct spanning many weeks, the defendant could not be characterized as a recidivist because there was no evidence that it had acted similarly toward other potential buyers. Accordingly, the court rejected the Court of Appeal's conclusion that the defendant's fraud in the context of an arms-length business transaction was highly reprehensible.

On the question of ratio, the court gave with one hand while taking away with the other. On the positive side, the court read *State Farm* as having established a presumption that ratios significantly greater than nine or 10 to one are suspect and cannot survive appellate scrutiny absent special justification. But the court went on to repudiate favorable language in the Court of Appeal's decision in *Diamond Woodworks, Inc. v. Argonaut Ins. Co.* (2003) 109 Cal. App.4th 1020, 1057. "[W]e do not agree with the court in [*Diamond Woodworks*] that 'in the usual case' the high court's decisions establish an 'outer constitutional limit' of approximately four times the compensatory damages." (2005 WL 1404425, at p. *12.)

More helpfully, the court emphasized that even single digit ratios are not presumptively valid, and may be suspect where compensatory damages are substantial. "Especially when the compensatory damages are substantial or already contain a punitive element, lesser ratios 'can reach the outermost



limits of the due process guarantee.” (*Ibid.*)

Like its discussion of ratio, the Supreme Court’s discussion of the defendant’s wealth is a mixed bag. On the surface, certain language in the opinion seems to suggest that, all things being equal, the constitutional maximum amount of punitive damages should be higher when the defendant is wealthier. But a closer reading reveals that the Supreme Court is not endorsing the imposition of giant punitive damages awards based on the fact that the defendant is wealthy. The opinion quotes from U.S. Supreme Court decisions for the proposition that wealth cannot be used as an open ended basis for affirming an otherwise unconstitutional punitive damages award. And the ultimate outcome of *Simon* makes clear that an award which is small in respect to the defendant’s net worth still has a deterrent effect. The court reduced the punitive damages award against San Paolo to \$50,000, concluding that such an amount was not insignificant when compared to the defendant’s net worth of \$46 million. The court noted that “even a prosperous company would ordinarily take reasonable measures to prevent the recurrence of a \$50,000 net loss.” (2005 WL 1404425, at p. *17.)

Johnson v. Ford

In *Johnson*, a lemon law case, the plaintiffs bought a used Ford that was still within the warranty period. The Ford dealer told the plaintiffs that the car had no record of significant repairs. In fact, the previous owners had experienced a recurring problem with the transmission and had received a \$1,500 “owner appreciation” certificate, which they used to trade in the car for a newer model. The plaintiffs experienced transmission problems shortly after they purchased the car. Ford made various unsuccessful attempts to fix the trans-

mission. When the plaintiffs discovered that the previous owners had experienced the same problem, they sued for fraud, unfair competition, and violation of the lemon law.

A jury awarded \$17,811.60 in compensatory damages and \$10 million in punitive damages. In an unpublished opinion, the Court of Appeal reversed, relying largely on the analysis set forth in the published decision in *Romo v. Ford Motor Co.* (2003) 113 Cal. App.4th 738 (*Romo*). Specifically, the court repeated its statement in *Romo* that, in accordance with *State Farm*, punitive damages must reflect only the amount necessary to punish and deter the conduct that injured the present plaintiffs. The court noted that during the trial, plaintiff’s counsel improperly asked the jury to award an amount of punitive damages representing all profit from Ford’s use of “owner appreciation” certificates in California over a two year period. Rejecting that disgorgement theory, the court reduced the award to three times the plaintiff’s compensatory damages.

The Supreme Court Opinion

In a 5-2 decision authored by Justice Werdegar, the California Supreme Court reversed. (*Johnson v. Ford Motor Co.* (June 16, 2005, S121723) ___ Cal.4th ___ [2005 WL 1404423] (*Johnson*).)

The court agreed with the Court of Appeal that the jury’s \$10 million punitive award could not be justified as a disgorgement of profits earned by Ford through its entire course of wrongful conduct toward other consumers. Such an approach creates possibilities for unfairness, both to the defendant and other possible plaintiffs. The court noted the potential for multiple punitive damage awards for the same misconduct. Even if future courts were to consider prior punitive awards, “there

is no guarantee the jury or the court will agree to deny the plaintiff before them recovery of punitive damages simply because another plaintiff, in another court, has already recovered.” (2005 WL 1404423, *10.) The court also noted a point emphasized heavily by Ford’s counsel at oral argument - that awarding a disgorgement theory to a single victorious plaintiff would be unfair to the defendant because even if the defendant wins nine out of ten trials involving the same misconduct, “a defendant that loses a single case would also lose the benefit of all previous victories against the same claim of misconduct.” (*Ibid.*)

The Supreme Court found, however, that the Court of Appeal had failed to adequately consider that Ford’s fraud was more reprehensible because it was part of a repeated corporate practice rather than an isolated incident. The Supreme Court concluded that neither *State Farm* nor *BMW* prohibit state courts from considering the defendant’s illegal or wrongful conduct toward others that was similar to the tortious conduct that injured the plaintiff. The Supreme Court sharply criticized the Court of Appeal’s decision in *Romo* for adopting an overly restrictive view of punitive damages, in which punishment can be imposed only for the particular harm to the plaintiff, and cannot represent a broader sanction for an affront to society at large.

The Supreme Court recognized that *State Farm* requires proportionality between punitive damages and the actual or potential harm to the plaintiff, and even conceded that in certain cases “the state may have to partly yield its goals of punishment and deterrence to the federal requirement that an award stay within the limits of due process.” (2005 WL 1404423, *9.) However, it held that the appropriate ratio necessarily depends on the reprehensibility

of the defendant's overall misconduct, including the frequency and profitability of similar conduct aimed at others.

The court summarized its holding: "The scale and profitability of a course of wrongful conduct by the defendant cannot justify an award that is grossly excessive in relation to the harm done or threatened, but scale and profitability nevertheless remain relevant to reprehensibility and hence to the size of the award warranted, under the guideposts, to meet the state's interest in deterrence." (2005 WL 1404423, *9.)

Conclusion

The *Simon* and *Johnson* opinions contain both positives and negatives for defense lawyers fighting against giant punitive damages awards. On the positive side, the decisions:

- reject the proposition appellate courts should defer to "implied" factual findings of the jury
- limit the extent to which plain-

tiffs can rely on potential harm to justify punitive damages

- clarify that "recidivism" refers to evidence of prior acts toward others, as opposed to multiple acts toward the plaintiff
- emphasize that the need for punitive damages is lessened by the presence of a large compensatory damages award
- reject an aggregate disgorgement theory of punitive damages; and
- recognize the unfairness of allowing a plaintiff to recover for harms caused to others without the formal strictures of a class action.

On the negative side, the decisions:

- invite plaintiffs to justify punitive damages awards based on evidence of harm that is not legally compensable

- authorize ratios in excess of single digits in cases of "extreme reprehensibility" or other "special justification"
- disparage helpful aspects of the opinions in *Diamond Woodworks* and *Romo*
- explicitly hold that the "scale and profitability" of a course of wrongful conduct is relevant to the determination of reprehensibility

In the end, the opinions leave much room for argument on wide array of issues, and ensure that excessiveness of punitive damages will continue to be an active area of litigation in the foreseeable future. 

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