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California Supreme Court Clarifies Rules for Punitive Damages Awards

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Since 1991, when the United States Supreme Court first suggested that the federal constitution's due process clause might place limits on punitive damages awards, courts have struggled to decide what the limits might be. Now, in two decisions issued on June 16, 2005, the California Supreme Court has entered the fray. Its opinions address (1) the proper ratio between punitive and compensatory damages and (2) the proper weight to be given to evidence that the defendant aimed other similar misconduct at people other than the plaintiff.

1. **The Court held that in calculating the proper ratio between punitive and compensatory damages, courts could consider "uncompensated" or "potential" harm to the plaintiff (in addition to compensated harm) but only if the uncompensated or potential harm was caused by the defendant's actionable misconduct.**

2. **The Court held that courts could consider the defendant's misconduct aimed at people other than the plaintiff, so long as the misconduct was similar, but ordinarily should not order the defendant to disgorge all its profits from similar misconduct aimed at others.**

For defendants, the results were mixed. The ruling on ratios probably will not benefit many defendants. In contrast, the ruling on misconduct aimed at others will benefit many plaintiffs, making both discovery and trials more complicated, although the Court's skepticism about disgorgement remedies, when coupled with the ruling on ratios, may help cap punitive damages.

1. The case about ratios is *Simon v. San Paulo U.S. Holding Company, Inc.*, 2005 WL 1404425 (Cal. June 16, 2005). The Court overruled a $1.7 million punitive damage award, holding that $50,000—that being ten times the jury's compensatory damages award of $5,000—was the maximum punitive damages award consistent with the federal due process clause.

In *Simon*, plaintiff tried but failed to buy an office building from defendant, which walked away from a letter of intent and sold the building to someone else. Simon's breach of contract claim failed, because the jury found that the letter was neither binding nor enforceable. But the jury did find that defendant had made a false promise to deal exclusively with Simon. The jury awarded Simon $5,000 in compensatory damages (the amount he spent to retain an attorney in reliance on

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the letter) and $2.5 million in punitive damages. The trial court ordered a new trial on punitive damages unless Simon agreed to reduce the award to $250,000. Simon declined, the issue of punitive damages was retried and this time Simon received an award of $1.7 million. The trial court let this award stand and the Court of Appeal affirmed—not once but three times, after two remands from the United States Supreme Court—the first for reconsideration in light of *Cooper Industries, Inc. v. Leatherman Tool Group, Inc.*, 532 U.S. 424 (2001), and the second for reconsideration in light of *State Farm Mut. Auto. Ins. Co.*, 538 U.S. 408 (2003).

Despite the three affirmances, State Farm presented plaintiff with a problem. *State Farm* held that "few awards exceeding a single-digit ratio between punitive and compensatory damages . . . will satisfy due process." 538 U.S. at 425. The ratio in *Simon* was 340 to 1. Simon argued that the award was justified because the building was worth $400,000 more than the agreed purchase price, and $1.7 million is only a little over four times $400,000.

The Supreme Court acknowledged that many cases had allowed the inclusion of uncompensated or potential harm in calculating the punitive/compensatory ratio. But in all such cases, the Court said, the uncompensated or potential harm actually had been caused by the wrongful act. Here, in contrast, the fraud did not cause the loss of the opportunity to gain $400,000. The defendant had a perfect right not to sell the building to Simon—after all, the jury had found that the letter of intent was not binding. What the defendant did not have a right to do was to string Simon along with false promises, thereby causing Simon to waste $5,000 hiring a real estate attorney he did not need. The Court contrasted this with other cases where the wrongful conduct actually had caused other harms that went uncompensated because (for example) of legal limitations on compensatory damages. In such cases, the Court said, one could consider the uncompensated damages in setting the punitive damages award. But here the fraud simply had not caused any harm of $400,000. Therefore, the $400,000 could not justify the punitive damages award.

The Court then applied State Farm to calculate an appropriate punitive damages award. *State Farm* says that courts should weigh three factors: "(1) the degree of reprehensibility of the defendant's misconduct, (2) the disparity between the actual or potential harm suffered by the plaintiff and the punitive damages award, and (3) the difference between the punitive damages awarded by the jury and the civil penalties authorized or imposed in comparable cases." *State Farm*, 538 U.S. at 418.

In *Simon*, the Court found that the harm was purely financial, Simon was not particularly vulnerable and defendant's misconduct was isolated if intentional. Thus, the degree of reprehensibility was fairly low. In contrast, the disparity between the punitive damage award and the actual damages (340 to 1) was very high—and way over single digits. Civil penalties were not really applicable and at most would have been in the low four figures. The Court therefore determined that a ratio of 10 to 1 was appropriate, even taking into account defendant's net worth ($46 million at the time of the wrong but $4.8 million by trial, owing to legitimate transfers to defendant's Italian parent). Thus, the Court reduced the punitive damages award to $50,000.

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2. The case about other misconduct is *Johnson v. Ford Motor Company*, 2005 WL 1404423 (Cal. June 16, 2005). Plaintiffs, the Johnsons, had bought a used Ford Taurus but were not told that the previous owner returned it in disgust because of recurring transmission failures. The jury found that Ford should have deemed the car a "lemon" under California's Lemon Law, in which case Ford would have had to replace the car or refund the original owner's purchase price and tell subsequent buyers such as the Johnsons that the car was a lemon. But Ford routinely construed the Lemon Law very narrowly, refused to deem cars lemons and instead offered buyers "Owner Appreciation Certificates" giving them a discount on another Ford product should they choose to trade in their lemon. In such cases, Ford made no disclosures to subsequent buyers such as the Johnsons. For a two-year period (albeit not the years in question), Ford had saved $6 million to $10 million a year throughout California from this practice.

The Johnsons sued Ford for fraud. Their lawyer argued to the jury that it ought to award at least enough to take away Ford's California-wide profits from disregarding the Lemon Law. The jury, evidently persuaded, awarded $17,811.60 in compensatory damages (essentially what the Johnsons had paid for the Taurus) and $10 million in punitive damages.

On appeal, the Court of Appeal reduced the punitive damages award to $53,435 (a 3 to 1 ratio), holding that the award must be limited to damages necessary to punish misconduct that harmed the plaintiffs, and not as a punishment for the defendant's overall bad course of conduct.

The Supreme Court disagreed with the Court of Appeal's analysis. Applying the three *State Farm* factors quoted above, the Court held that a defendant's pattern or practice of engaging in misconduct could be considered when determining the defendant's degree of reprehensibility (factor 1) and in determining the ratio between punitive damages and compensatory damages (factor 2). But, said the Court, the other conduct must be similar to that causing injury to the plaintiff. Generalized evidence that the defendant was bad should not be considered. The Court said that using other similar bad acts in determining factors 1 and 2 did not punish the defendant for its conduct toward others, but merely placed in context the defendant's conduct toward the plaintiff, revealing the need for a stronger penalty.

The Court then turned to Johnsons' "aggregate disgorgement" theory. Without deciding whether due process would ever allow the use of this theory, the Court rejected its use here for several reasons. First, the Johnsons proved only the facts of Ford's misconduct to them, but did not prove that Ford's other uses of "Owner Appreciation Certificates" all involved vehicles with serious defects, or that Ford or its dealers had made similar misrepresentations in those cases. Second, the Johnsons offered no reason for using data on certificate use in 2000-01 when the Johnsons had bought their Taurus in 1997. The Court also noted that an award to one plaintiff of all of a defendant's profits from misconduct directed at others raised the possibility of duplicative awards against the defendant, or of depriving later plaintiffs of a shot at a punitive damages award, all without the protections normally afforded in a class action or a mass action where all interested parties are represented.

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Simon and *Johnson* clarify the law of punitive damages and should deter the use of some of the more extreme theories advanced by plaintiffs—particularly, the aggregate disgorgement theory. But overall these cases offer defendants little solace. In few cases will we see the fact pattern of *Simon*. But in many cases plaintiffs will seek broad discovery of the defendant's conduct toward nonparties and then make broad arguments about such evidence at trial. Had the focus of punitive damages cases been limited to the defendant's conduct toward the particular plaintiff at bar, as the Court of Appeal had held in *Johnson*, some of the expense and risk of punitive damages cases would have been reduced. As it is, litigating punitive-damages cases likely will remain expensive and risky, although less risky than it was before the United States Supreme Court's decision in *State Farm*.

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