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Litigation Alert

California Supreme Court Clarifies Guidelines for Punitive Damages

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Two years after the U.S. Supreme Court’s opinion in *State Farm v. Campbell*, the California Supreme Court has clarified the guidelines for imposition of punitive damages in *Simon v. San Paolo U.S. Holding Co.* and *Johnson v. Ford Motor Co.*

The California Supreme Court issued two important rulings in June 2005, taking up the constitutionality of punitive damage awards in light of the guidelines established by the U.S. Supreme Court in *State Farm Mutual Auto. Ins. Co. v. Campbell*, 538 U.S. 408 (2003). In *Simon v. San Paolo U.S. Holding Co.*, 05 C.D.O.S. 5207 (2005), the court reduced the punitive damages awarded from \$1.7 million to \$50,000. In *Johnson v. Ford Motor Co.*, 05 C.D.O.S. 5215 (2005), the court reversed the appellate court’s reduction of a jury award of \$10 million to \$53,435 and remanded for further consideration.

Key holdings from the cases:

- While uncompensated and “potential” harm may be considered in determining punitive damages, such harm must be caused, or foreseeably threaten to be caused, by defendant’s misconduct. (*Simon*.)
- A defendant’s wealth may not displace the U.S. Supreme Court’s “guideposts” limiting awards, and cannot alone justify a high award. In determining whether an award satisfies the state’s legitimate interest in deterrence, however, a jury may nonetheless consider defendant’s financial condition. (*Simon*.)
- Disgorgement of aggregate profits from similar misconduct is improper as a per se means of determining punitive damages. However, the frequency and profitability of misconduct may serve as a gauge for measuring reprehensibility, a key factor in assessing punitive damages under *Campbell*. (*Johnson*.)

Background: In *Campbell*, the U.S. Supreme Court fleshed out the three “guideposts” in determining the

constitutionality of punitive damage awards that it had previously enumerated in *BMW of North America, Inc. v. Gore*, 517 U.S. 559 (1996):

- 1) The reprehensibility of defendant’s misconduct; factors to be considered include:
 - A. Whether the harm caused was physical as opposed to economic,
 - B. Whether the misconduct evinced an indifference to or reckless disregard of the health or safety of others,
 - C. Whether the target of the misconduct was financially vulnerable, and
 - D. Whether the misconduct involved was repeated or an isolated incident;
- 2) Whether the harm was the result of intentional malice, trickery, or deceit, as opposed to being accidental;
- 3) The disparity between the actual and potential harm suffered by plaintiff and the punitive damages award; and
- 4) The difference between the punitive damages awarded and the civil penalties authorized or imposed in comparable cases.

To ensure that punitive damages are reasonably tethered to plaintiff’s harm, the U.S. Supreme Court in *Campbell* held that there is a presumptive preference for single-digit ratios—that is, punitive damages lower than 10 times the actual or potential harm to plaintiff. In application, this presumption anchors the range of possibilities that are likely to pass constitutional muster. The first and third guideposts—reprehensibility and comparable civil penalties—assist in deciding where in that range the award appropriately falls. Punitive damages in excess of single-digit ratios are possible in cases egregious enough to

rebut the preference. However, the U.S. Supreme Court in *Campbell* indicated that “few” awards above the single-digit range will satisfy due process.

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

The facts of *Simon*. After a failed attempt to purchase an office building from defendant, plaintiff sued for breach of contract and promissory fraud. The jury determined that there was no enforceable contract, but found for plaintiff on the promissory fraud claim. The jury awarded only \$5,000 in compensatory damages (for money plaintiff had spent to retain a lawyer to complete the failed transaction) and \$1.7 million in punitive damages. The Court of Appeals affirmed, measuring the punitive damages not against the \$5000 in actual damages, but against uncompensated or “potential” harm. Plaintiff had claimed uncompensated harm of \$400,000 for profits he asserted he would have made had the sale gone through. Alternatively, plaintiff argued that defendant’s misconduct threatened potential harm in excess of \$400,000 on the theory that, had plaintiff given up his leased business premises with the expectation of acquiring the new building, he would have “found himself on the street” when defendant pulled out of the sale. The California Supreme Court reversed and awarded punitive damages of \$50,000, ten times the *actual* damages.

Uncompensated or potential harm must be foreseeable.

In *Simon*, the California Supreme Court acknowledged that uncompensated or potential harm may properly be considered in assessing the appropriate ratio for a punitive damages award. However, the *Simon* court determined that the uncompensated or potential harm claimed by plaintiff was neither caused nor foreseeably threatened by defendant’s promissory fraud. The court noted that the potential injuries claimed by plaintiff, such as the risk of having no place to operate his business, would not have been foreseeable to defendant as a consequence of his misconduct. In view of this lack of causation or foreseeability, it was improper to consider plaintiff’s claimed \$400,000 potential loss in evaluating the appropriate ratio for punitive damages.

Evidence of defendant’s financial condition may be considered, subject to due process limitations. The *Simon* court also held that evidence of a defendant’s financial condition may be considered in awarding punitive damages, because states have a legitimate interest in preventing future misconduct by allowing juries to set awards high enough to have deterrent value. However, a defendant’s

wealth cannot substitute for the *Campbell* “guideposts,” in justifying a high award. The court noted that in some cases, defendant’s financial condition may combine with particularly reprehensible conduct and a low compensatory award to justify an extraordinary ratio between compensatory and punitive damages.

In *Simon*, the court determined that the reprehensibility of defendant’s conduct was relatively low. Although there was evidence of trickery or deceit, the harm was economic, the healthy and safety of others was never compromised, plaintiff’s financial vulnerability was disputed, and there was no evidence that defendant treated other buyers similarly. As a result, notwithstanding defendant’s wealth, an award in excess of ten times compensatory damages was not justified.

Johnson v. Ford Motor Co.

The facts of *Johnson*. Plaintiffs in *Johnson* purchased a used Ford Taurus from an auto dealer. When they asked about the previous ownership of the vehicle, they were told that it had been traded in on a newer model. In fact, the car had previously had numerous repairs to its transmission, to the point where it was seemingly unrepairable. Nevertheless, Ford’s district customer service manager determined that the car did not qualify for mandatory repurchase under California’s Lemon Law. Instead, Ford had encouraged the previous owners to trade in the car on a new model, by offering them an “owner appreciation certificate” (OAC) of \$1500. Not surprisingly, the car’s transmission problems continued after plaintiffs purchased it. They sued Ford for intentional and negligent misrepresentation and concealment, violations of the Song-Beverly Consumer Warranty Act (Cal. Civ. Code §§ 1790-1795.7) (Lemon Law), and the Consumer Legal Remedies Act (Cal. Civ. Code §§ 1750-1784).

At trial, plaintiffs presented evidence of Ford’s corporate policies and practices regarding reacquisition of vehicles and issuance of OACs. They showed that Ford managers “employed a narrow concept of what constitutes a repair attempt for purposes of applying state lemon laws” in order to avoid mandatory repurchases. Managers also regarded the OACs as assistance to the customer, not the dealer, in order to avoid mandatory notification to future buyers under California law, which mandates notification regarding defects that led to reacquisition by the dealer with manufacturer assistance. The jury awarded \$17,811.60 in compensatory damages and \$10 million in punitive

damages—over 500 times actual damages. The Court of Appeals determined that \$10 million was not constitutionally justified and reduced to \$53,435. The California Supreme Court affirmed that \$10 million was excessive, but remanded for a consideration of Ford’s recidivist misconduct as factoring into reprehensibility.

Recidivist conduct may be considered in evaluating “reprehensibility,” but the prior conduct must be similar to the conduct at issue. The court in *Johnson* noted that frequency of misconduct and (ill-gained) profitability can be key indicators of reprehensibility, “the most important indicium of the reasonableness of the award.” However, to be considered, prior and contemporaneous conduct must be the same type of conduct as the misconduct that harmed plaintiff. Defendant’s “bad” practices in general may not be considered.

In *Johnson*, the court explained that Ford’s exact conduct toward plaintiff was apparently repeated toward others in California as part of Ford’s business practices, and accordingly should be considered in assessing reprehensibility. The court further went on to distinguish the case from *Campbell*, where plaintiffs produced little evidence of repeated misconduct of the type that injured them, and the jury was punishing defendant for other perceived deficiencies in its operations throughout the country. Based on the lower court’s apparent failure to consider similar conduct by Ford, the court overturned the lower court’s reduction of the award to \$53,435 (an amount three times compensatory damages). Thus on remand, the ultimate award could be higher than the reduced amount awarded by the Court of Appeals.

Disgorgement of aggregate profits is improper. Although the court determined that recidivism is relevant, it rejected plaintiff’s aggregate disgorgement theory of punitive damages. The court rejected the notion that punitive damages should be used to recover Ford’s profits from its reacquisition and OAC practices throughout California, noting that it would be unfair to defendants—who would be over-punished—and other possible claimants—who would be denied the right to recover. Aggregate disgorgement would also create disproportionate awards in excess of single-digit ratios in almost every case. Finally, it would allow plaintiffs to recover for misconduct affecting a large

class without the formalities that accompany a class action suit. For example, in this case, the court could not assume, without proof, that every reacquisition and use of an OAC in California was unscrupulous.

Lessons:

- Uncompensated or “potential” harm, a concept previously left unconstrained in *BMW* and *State Farm*, is limited by *Simon* to those harms that are foreseeable. By clarifying this boundary, potential defendants are no longer threatened by the possibility of paying punitive damages based on a multiple of unrealized damages that they could not have reasonably anticipated.
- Defendants in punitive damages cases will still be required to produce evidence concerning their financial condition, and wealthy defendants may face punitive damages in the higher single-digits, in order to deter future misconduct, as approved in *Simon*.
- The guideposts in *State Farm* were created as a compromise between subjectivity and numerical rigidity. The *Johnson* decision appears to indicate that courts can, and possibly should, give the more subjective guidepost, reprehensibility, more weight than the more numerical guidepost, comparable civil penalties. This may lead to more awards at the higher end of the single-digit ratio.
- The *Johnson* case highlights the fact that there may be a fine line between acceptable business practices and those deemed “reprehensible.” Ford may have genuinely believed that its conduct complied with California law, and that it was not legally required to make any disclosure to the new purchasers. The majority in *Johnson* apparently viewed Ford’s “narrow” reading of the California Lemon Law as so egregious that they rejected the Court of Appeal’s reduction of the punitive damages award to only one factor over the applicable civil penalty. And judging by the original \$10 million punitive damages award, the jury clearly found the conduct to be egregious. In contrast, in his concurring opinion, Justice Chin questioned whether Ford’s conduct was as reprehensible as the Court of Appeals suggested, noting “there is a difference between *avoiding* a law by a narrow interpretation and *evading* a law by ignoring or knowingly violating it.” Businesses should be cautious to avoid such “narrow” readings of the law, particularly in areas such as public safety, consumer protection and employment discrimination.