

DEFENDING AGAINST PUNITIVE DAMAGES

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I. INTRODUCTION

Punitive damages are the driving force behind bad faith cases. Although extra-contractual damages for emotional distress, economic loss, interest and attorney's fees can be staggering, it is punitive damages that pose the greatest threat to insurers and the greatest allure to plaintiffs.

Punitive damages constitute more than a quarter of the total dollars awarded by juries. The overall average punitive damage award is \$3.3 million. In 1996, punitive damages estimated at \$637 million were awarded to 5% of plaintiff winners in trial cases². The largest punitive damage award rendered by a jury was in Harris County, Texas. It was a negligence action involving 22 plaintiffs and six defendants. The jury awarded \$5.4 million in compensatory damages and \$138 million in punitive damages³.

A study of 1,000 lawsuits in San Francisco Superior Court conducted by Pacific Research Institute found that businesses and government defendants face punitive damages in one-third of all lawsuits against them. Although the plaintiffs did not recover punitive damages every time, the additional cost in defending against them was reflected in the fact that cases in which punitive damages were sought took 40 percent longer to resolve than cases without punitive claims.

A recent report published by the Rand Institute⁴ on punitive damages found that most of the punitive damage awards occurred in insurance, employment and real property disputes. Between 1985 and 1994, 13% of the verdicts in insurance cases included punitive damages. The report also found that punitive damage awards are almost four times compensatory awards in insurance verdicts. Punitive damages are awarded more often in California totaling 20% of all financial injury⁵ verdicts in California. Of particular interest, the Rand Institute's report contained a separate section on punitive damage awards in the state of Alabama. During the period of 1992 to 1997, punitive damages represented between 80%-86% of all damages awarded in all financial injury

² See Carol J. DeFrances, Ph.D. and Marika F.X. Litras, Ph.D survey on *Civil Trial Cases and Verdicts in Large Counties, 1996*, Civil Justice Survey of State Courts, 1996, Bureau of Justice Statistics Bulletin, U.S. Department of Justice. The report compiled statistics from the state courts of general jurisdiction in the Nations's 75 largest counties of cases (e.g. tort, contract and real property) disposed of by trial between January and December 1996.

³ *Id.* at 10.

⁴ See study conducted by Erik Moller, Nicholas Pace, and Stephen Carroll for the Institute of Civil Justice and published as *Punitive Damage Awards in Financial Injury Jury Verdicts, 1997*. The study was based on data collected during 1985-1994 in all state trial courts of general jurisdiction in California, New York state, Cook County, Illinois (Chicago), the St. Louis, Missouri metro area and Harris County, Texas (Houston). The study also compiled data from 1992-1997 in Alabama.

⁵ "financial injury" verdicts involve cases which are financial in nature and comprise of disputes arising from contractual or commercial relationships.

verdicts. The study found that in Alabama punitive damages are awarded more often and are higher in any given case relative to compensatory damages than in the other jurisdictions in the Institute's database.

There is also some evidence that punitive damage awards can affect a company's stock price and sales of its products. According to a study by Steven Garber, an economist at the Rand Institute, whether a case involves a punitive damage award is a fairly substantial factor in whether or not newspapers run a story. "People will say that punitive damages are usually reduced or thrown out on appeal. But even if you ultimately win, it doesn't mean punitive damages didn't cost you."

In June 1993, the U.S. Supreme Court, in *TXO Production Corp. v. Alliance Resources Corp.*,⁶ refused to overturn an award of punitive damages over 500 times greater than the compensatory damages award. In May 1996, the U.S. Supreme Court reached the opposite result and overturned a punitive damages award 500 times greater than the compensatory award in *BMW of North America, Inc. v. Gore*.⁷ Although at first glance, these cases appear to define the Court's stance on punitive damages, the holdings actually are much more ambivalent. The impact of these cases is equally unclear. *BMW*, *TXO* and other U.S. Supreme Court decisions on punitive damages demonstrate emphatically the need to raise and preserve every procedural and substantive defense and appellate issue throughout the litigation.

To provide context, this article begins with a brief overview of the historical background of punitive damages theory. Next, it discusses contemporary legal principles on punitive damages and analyzes *BMW*, *TXO* and other significant U.S. Supreme Court cases. Finally, the article recommends specific strategies and defenses to minimize or eliminate punitive damage exposure.

II. THE ORIGIN AND DEVELOPMENT OF PUNITIVE DAMAGES THEORY

A. Historical Background⁸

The concept of limitations on punitive damages awards is not new. In fact, the Magna Carta of thirteenth century England created the principle of proportionality by prohibiting "amercements," or monetary fines, that were disproportionate to the offense committed or deprived the defendant of his means of livelihood. In private suits, the court would amerce a fine either on the losing plaintiff for his false claim or on the losing defendant for his misconduct. The imposition of an amercement involved a two part procedure: the court initially assessed the penalty, and then a jury comprised of the amerced party's

⁶ 509 U.S. 443, 113 S. Ct. 2711, 125 L.Ed.2d 366 (1993).

⁷ 517 U.S. 559; 116 S.Ct. 1589; 134 L.Ed.2d 809.

⁸ See generally Note, *The Constitutionality of Punitive Damages Under the Excessive Fines Clause of the Eighth Amendment*, 85 Mich. L. Rev. 1699 (1987).

peers adjusted that penalty in accordance with the party's misconduct and ability to pay. The amercement ultimately would be paid to the court.

From the Magna Carta (and subsequently the English Bill of Rights and the Virginia Declaration of Rights of 1776), the American Bill of Rights acquired the language and meaning of its Eighth Amendment. The Eighth Amendment provides, "Excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishment inflicted."⁹ The framers of the Bill of Rights incorporated the Eighth Amendment to curtail excessive judicial power largely in response to complaints that the original Constitution failed to limit the degree of punishment imposed on convicted offenders.

Many courts have refused to apply the Excessive Fines Clause to civil punitive sanctions based on the opinion that the "Excessive Fines Clause" of the Eighth Amendment is categorically the same as the "Cruel and Unusual Punishment" and "Excessive Bails" Clauses of the Eighth Amendment which only apply in criminal cases. The U.S. Supreme Court's decision in *Ingraham v. Wright* (1977),¹⁰ in which the Court held that the Eighth Amendment's Cruel and Unusual Punishment Clause did not apply in civil cases, provides derivative support. Consequently, *Ingraham* has been interpreted as restricting the Eighth Amendment's Excessive Fines Clause to a criminal setting.¹¹

⁹ U.S. Const. amend. VIII.

¹⁰ 430 U.S. 651 (1977).

¹¹ Although the *Ingraham* case was a class action comprised of students subjected to corporal punishment at the Dade County, Florida, public school system, it revolved around two junior high school students who had been paddled. The first student suffered a hematoma after being paddled over twenty times for slowly responding to his teacher's instructions. The second student was struck on the arms on two occasions, once depriving him of the full use of his arm for a week. The Court refused to extend the Cruel and Unusual Punishment Clause to include corporal punishment, because it held the Eighth Amendment was designed to protect those convicted of a crime. The Court reasoned that public schools were open to public scrutiny and were supervised by the community, thereby providing sufficient safeguards for similar abuses against which the Eighth Amendment was designed to protect the prisoner. Additionally, these safeguards were reinforced by common law legal constraints imposing both criminal and civil liability under state law against teachers and administrators in situations where any punishment exceeded what was "reasonably necessary" for a child's proper education and discipline.

Four justices dissented, stating that the Eighth Amendment reflected a societal judgment that punishments extending beyond the individual's dignity so as to be barbaric and inhumane deserved Eighth Amendment protection, no matter what the nature of the offense for which the punishment was imposed. They also pointed out that the Eighth Amendment had never been confined to criminal punishments, i.e., punishments inflicted for the commission of a crime, despite the majority's insistence that any protections afforded by the Eighth Amendment only involved criminals--and thus only applied to criminals.

Further, in *Browning-Ferris Industries of Vermont, Inc. v. Kelco Disposal, Inc.*,¹² set forth more fully below, the U.S. Supreme Court refused to extend the prohibition of excessive fines under the U.S. Constitution to punitive damages awards in cases between private litigants.

B. Contemporary Theory

Although objections based on the Excessive Fines Clause of the Eighth Amendment have been the most common, punitive awards also have been attacked on other grounds, including due process, void-for-vagueness, double jeopardy, and freedom of speech and press. Punitive damages also can be challenged on the basis of the Commerce Clause, Privileges and Immunities Clause, and Equal Protection Clause, all of which prohibit arbitrary, status-based discrimination.

The due process language of the Fourteenth Amendment mirrors the federal Due Process Clause of the Fifth Amendment: no person shall be deprived of life, liberty, or property without due process of law. The Supreme Court has divided due process rights into two prongs--procedural and substantive. "Procedural due process" refers to procedural safeguards to insure a fair process, such as adequate notice, an opportunity for a hearing, the right to confront and cross-examine adverse witnesses, the right to an unbiased decision-maker, and so on. "Substantive due process" guarantees that the substance of the laws will be reasonable. Both procedural and substantive due process, in addition to other constitutional protections, are common challenges to alleged abuses in varied circumstances.

C. Current Case Law

In 1989, the U.S. Supreme Court first addressed the punitive damages issue head-on¹³ in *Browning-Ferris Industries of Vermont, Inc. v. Kelco Disposal, Inc.*¹⁴ The *Browning-Ferris* case arose from a local waste disposal company's federal district court action against a nationwide waste disposal company. In its complaint, Kelco Disposal alleged that Browning-Ferris had violated federal antitrust law by attempting to monopolize a part of the waste disposal market and had violated state tort law by interfering with the claimant's contractual relations. The jury found in favor of Kelco and awarded \$51,146 in compensatory damages for both counts and \$6 million in punitive damages--117 times the actual damages. The U.S. Court of Appeals for the Second Circuit upheld the jury's verdict.

On certiorari, the U.S. Supreme Court affirmed. Noting its past history of applying the Eighth Amendment to criminal prosecutions and punishments, the Court refused to

¹² 492 U.S. 257 (1989).

¹³ The Court avoided the issue in *Aetna Life Insurance Co. v. Lavoie* 475 U.S. 813 (1986); 492 U.S. 257 (1989). It avoided the issue again in *Bankers Life & Casualty Co. v. Crenshaw* 486 U.S. 71 (1988)

¹⁴ 492 U.S. 257 (1989).

extend the Eighth Amendment's Excessive Fines Clause to punitive damages awards between private parties. However, the Court did not go so far as to hold that the Excessive Fines Clause **only** applied to criminal cases. The Court recognized a possible exception where the government had prosecuted the action or had a right to receive a share of the damages awarded. It reasoned that the Eighth Amendment primarily focused on the potential for governmental abuse of its prosecutorial power, and nothing in English history suggested that the Excessive Fines Clause was intended to apply to private party disputes.

The Court also refused to decide whether the excessiveness of a punitive damages award violated the Due Process Clause of the Fourteenth Amendment, largely because *Browning-Ferris* failed to claim that the proceedings themselves were unfair or that the jury was biased or blinded by prejudice or emotions. Instead, *Browning-Ferris* raised due process objections related solely to the size of the punitive damages award. Although the Court noted that some authority existed for the view that the Due Process Clause placed outer limits on an award's size made pursuant to a statutory scheme, it would not consider whether due process acted as a check on undue jury discretion to award punitive damages in the **absence** of any express statutory limit. Thus, because *Browning-Ferris* did not raise the due process argument before any of the lower courts or make any special mention of it in its petition for certiorari, the Court refused to consider any due process objection.¹⁵

Justices Brennan and Marshall joined the Court's opinion with the express reservation that the Court leave open for future consideration the issue of due process constraints on punitive damages awards in civil cases brought by private parties. Justices O'Connor and Stevens, concurring in part and dissenting in part, observed that nothing in the Court's decision foreclosed a due process challenge to punitive damages awards.

¹⁵ The Court also held that the punitive damages award was not excessive as a matter of federal common law. The Court's power of review extended only to a determination of whether the Court of Appeals erred in finding that the District Court did not abuse its discretion by refusing to grant *Browning-Ferris*' motion for a new trial or remittitur. (This is because federal law controls issues involving the proper review of a jury award by a federal district court and appellate court.) The District Court's role, in turn, was to determine whether the jury's verdict fell within the confines of state law in deciding whether to order a new trial or remittitur.

The Supreme Court did **not** have the power to craft some standard for excessiveness based on notions of proportionality, because this was a state law matter. That is, state law provided the basis of decision, the propriety of the award for the conduct in question, and the factors considered by the jury in determining the amount. Thus, because the Court knew of no federal common-law standard or compelling federal policy which would render the Court unable to defer to the District Court's decision, the Court concluded that federal common law did not provide a basis for disturbing the punitive damages award.

The Court finally reached the due process issue in *Pacific Mutual Life Insurance Company v. Haslip* (1991).¹⁶ *Haslip* involved an Alabama-licensed agent for two distinct and non-affiliated insurance companies, one of which was Pacific Mutual. The agent issued certain policies to city employees and collected payment for the premiums from the city clerk who had deducted respective amounts from the employees' paychecks. The agent subsequently misappropriated most of those payments. When Pacific Mutual canceled coverage based on lack of payment, the agent did not send notices of the cancellation to the employees. Eventually, four employees filed suit in state court, based on the agent's fraud, against Pacific Mutual under a respondeat superior theory¹⁷ and against the agent, individually and as a proprietorship.

At trial, the jury was instructed that it could award punitive damages if it found fraud. Pacific Mutual neither objected to the instruction on the ground of lack of specificity nor submitted a more tailored instruction. No evidence of Pacific Mutual's wealth was introduced. Following the trial, the jury returned general verdicts against Pacific Mutual and the agent. The verdicts did not specify whether or not punitive damages had been awarded. The court inferred an award of punitive damages because the amount of the verdict greatly exceeded the compensatory damages.

In affirming the punitive damages portion of the award, the Court generally reaffirmed its confidence in the traditional, common-law approach to awarding punitive damages, namely, a properly-instructed jury initially calculated the amount of the award, and that determination then was reviewed by trial and appellate courts to insure its reasonableness. The Court did not find the common-law method for assessing punitive damages to be so inherently unfair as to deny due process, particularly because it was well established even before the Fourteenth Amendment was enacted. In essence, the Court approved the punitive damages award based in large part on its perception that Alabama's two-tier judicial review process offered detailed and objective safeguards against unfair punishment. Further, nothing in that amendment's text or history indicated that the drafters intended to overturn the prevailing method. Nonetheless, the Court acknowledged that unlimited jury discretion could result in violations of a defendant's constitutional rights.

The Court generally recognized that the Due Process Clause imposed limits on punitive damages awards but refused to elaborate on the difference between constitutionally acceptable and unacceptable standards as they applied to every case. Rather, the Court stated that "general concerns of reasonableness and adequate guidance from the court when the case is tried to a jury properly enter into the constitutional calculus."¹⁸ Thus, despite its promise in *Browning-Ferris* to resolve the issue, the *Haslip* Court instead limited its decision to the **reasonableness** of the jury's discretion (whose award did not

¹⁶ 499 U.S. 1 (1991).

¹⁷ "Respondeat superior" means "let the master answer." Under a "respondeat superior" theory, an employer may be held liable in certain cases for the wrongful acts of his or her employee which occur within the scope of employment.

¹⁸ *Id.* at 18.

"cross the line into the area of constitutional impropriety,"¹⁹) without providing any guidance as to whether other procedures were sufficiently "reasonable." *Haslip* thereby perpetuated the uncertainty of a constitutional challenge to punitive awards.

III. THE *TXO* DECISION

A. Factual Background

TXO involved a \$10 million punitive damage award imposed against TXO Production, a subsidiary of U.S.X. Corporation (formerly U.S. Steel). Alliance Resources Corp. sued TXO for slander of title. According to Alliance's version of the facts, TXO had maliciously but unsuccessfully attempted to defraud Alliance of potentially lucrative oil and gas development rights in West Virginia. As an element of an alleged widespread pattern and practice of similar bad faith business dealings in other parts of the country, TXO filed a frivolous declaratory judgment action alleging a cloud on Alliance's title to the oil and gas rights and procured false testimony to support its attack on Alliance's title. The liability and punitive phases of the trial were not bifurcated. During the trial, Alliance introduced evidence of prior, similar misconduct on the part of TXO and also introduced evidence of the net worth of TXO's corporate parent which was not a party to the litigation.

The jury returned a verdict of \$19,000 in actual damages, representing Alliance's costs of defending the quiet title suit brought by TXO as part of its fraudulent scheme, and \$10 million in punitive damages to punish TXO.

The Supreme Court of Appeals of West Virginia affirmed, rejecting TXO's argument that the punitive damage award was constitutionally excessive because it was grossly disproportionate to the actual damage award. The court used *Haslip* and the factors for reviewing punitive damages as set forth in *Garnes v. Fleming Landfill*²⁰, a West Virginia case decided after the *TXO* trial court decision but prior to the appeal, as guidelines to decide the amount of punitive damages awarded was proportionally related to the harm that was likely to occur from a defendant's conduct as well as harm that actually had occurred. The court distinguished "really mean" defendants from "really stupid" defendants to explain the "reasonable relationship" between the award and the conduct. The court determined the outer limit of punitive damages for "really stupid" defendants was approximately 5:1, whereas, by contrast, punitive damages for "really mean" defendants would necessarily be higher for deterrence purposes. The court affirmed the punitive damages award because of the reprehensibility of TXO's conduct and the need to impose a large penalty on TXO to discourage its continuing pattern and practice of deceit that could have caused millions of dollars in losses to future victims.

¹⁹ *Id.* at 24.

²⁰ 186 W. Va. 656, 413 S.E.2d 897 (1991).

B. The U.S. Supreme Court Decision

On certiorari, the U.S. Supreme Court affirmed. In *TXO Production Corp. v. Alliance Resources Corp.*²¹ six Justices rejected TXO's due process challenge. The decision was split as to the court's reasons for affirming the decision.

Justice Stevens authored the plurality opinion which Chief Justice Rehnquist and Justice Blackmun joined. At the outset, the Court reiterated its "general concern for reasonableness" as the appropriate constitutional standard of review of punitive damages awards. The Court then rejected TXO's contention that the punitive damages award against TXO was "grossly excessive," given the prospect of tremendous financial gains, TXO's bad faith, its pattern of fraud and deceit, and its vast wealth. The Court also concluded that a defendant's "financial position" was a proper factor for the jury to consider in its punitive damage assessment, although it agreed with TXO that "the emphasis on the wealth of the wrongdoer increased the risk that the award may have been influenced by prejudice against large corporations, a risk that is of special concern when the defendant is a nonresident." Finally, the Court found TXO had been given an adequate hearing and proper notice.

In a concurring opinion, Justice Scalia, joined by Justice Thomas, opined that no substantive due process right to "reasonable" punitive damages exists. Rather, the Court's sole jurisdiction for such matters was to ensure that procedural due process safeguards were in place; "**judicial** assessment of their reasonableness is a federal right, but a **correct** assessment of their reasonableness is not."²² Justice Kennedy also concurred with the judgment but opined that the Court's constitutional inquiry should focus on the jury's reasons for the award rather than on the amount awarded.

Justice O'Connor, joined by Justice White and by Justice Souter in part, dissented, expressing disappointment over the Court's failure to apply sufficient constitutional scrutiny to "restore fairness in what is rapidly becoming an arbitrary and oppressive system."²³ She stressed the need for judicial intervention to provide necessary guidance for juries and to establish some objective criteria to ensure that any punishment was proportional to the offense as implicitly required by the Due Process Clause.

The only legal issue *TXO* resolved is that a wide ratio between punitive and compensatory damages is not unconstitutional per se; the Court did not eliminate constitutional challenges to punitive damages awards. Further, while a clear majority rejected a bright-line standard for reviewing **substantive** due process objections, the Court will entertain **procedural** due process objections.²⁴ Thus, if anything, *TXO*

²¹ 509 U.S. 443, 113 S. Ct. 2711, 125 L.Ed.2d 366 (1993).

²² *Id.*, 125 L.Ed. at 388 (emphasis original).

²³ *Id.*, 125 L.Ed. at 389.

²⁴ This was further demonstrated in the U.S. Supreme Court decision in *Honda Motor Co. v. Oberg*, 512 U.S. 415 (1994). There, the Court reversed a \$5 million punitive award on the grounds that Oregon's lack of judicial review of awards violated the Due Process Clause of the Fourteenth Amendment. Because Oregon was the only
(More)

demonstrates the need to raise procedural due process objections at every stage of the case.

IV. THE *BMW* DECISION

A. Background

In January 1990, Dr. Gore purchase a BMW sports car for \$40,000 from an authorized BMW dealer in Birmingham, Alabama. After driving the car for approximately nine months without noticing any flaws in its appearance, Dr. Gore took the car to "Slick Finish," an independent detailer to make it look "snazzier than it would normally appear." Mr. Slick detected evidence the car had been repainted. Dr. Gore ultimately discovered that the car had been repainted to repair acid rain damage after the car had left the factory.

Dr. Gore sued BMW for failing to tell him that his car had been damaged and repainted. A jury found in Dr. Gore's favor and awarded \$4,000 in damage for the diminution in value of the car and \$4 million in punitive damage against BMW.

B. The U.S. Supreme Court Decision

Although the Alabama Supreme Court slashed the punitive award to \$2 million, the U.S. Supreme Court found that even \$2 million was so "grossly excessive" that it violated the due process clause of the Fourteenth Amendment. The justices still declined to specify a ratio of punitive to compensatory damages beyond which a damage award would clearly be unconstitutional. However, the Court offered three "guideposts" for assessing whether a punitive award goes over the line.

The first is the punitive-to-compensatory damages ratio. The Court found that because the \$2 million award was 500 times the amount of the actual harm, and there was no suggestion that Dr. Gore was threatened with additional potential harm, the punitive award was excessive. However, the Court noted it was not possible to "draw a mathematical bright line between the constitutionally acceptable and the constitutionally unacceptable that would fit every case," instead finding that the ratio in this instance was clearly outside the acceptable range.

The second guidepost is the "degree of reprehensibility of the defendant's conduct," described by the Court as the most important indicium of the reasonableness of a punitive damages award. Here, the Court emphasized that the harm BMW inflicted on Dr. Gore was purely economic. There was no evidence of BMW's indifference to or reckless disregard for the health and safety of others, nor was there any evidence that BMW engaged in deliberate false statements, acts of affirmative misconduct, or concealment of evidence of improper motive.

remaining state which did not allow review of punitive damages, the *Honda* decision did not impose any new constitutional limits on punitive damage awards.

The third guidepost is the relationship of the punitive damage award to the criminal fines that could be imposed for similar conduct in criminal court. In *Gore*, the automaker could have faced a maximum \$2,000 fine for failing to disclose the paint job, the Court found. Obviously, \$2 million is substantially greater than a \$2,000 fine, and therefore, there was nothing that would have put BMW on notice that it might be subject to a multi-million dollar sanction.

C. Analysis

It is difficult to predict with certainty the impact that the **BMW** decision will have on punitive damage awards. However, at least one commentator has concluded that its impact has been dramatic in federal and to a lesser extent state appellate courts than expected.²⁵ Speculation is that courts have invoked the ruling at least twenty times to slash multi-million dollar punitive awards. Several state supreme courts have declined to use the ruling to overturn punitive awards in personal injury cases, pointing out that the plaintiff in **BMW** had suffered an economic loss, but no physical damage. However, federal courts have liberally used the case to slash punitive awards.²⁶

1. The State Farm case

In what appears to be an unusual verdict rendered by a judge, in **Avery v. State Farm Mutual Auto Ins. Co.**²⁷ a judge ordered State Farm to pay \$600 million in punitive damages for defrauding millions of policyholders by violating contract terms and using imitation parts to repair their customers' vehicles. A jury verdict of \$456 million was awarded as compensatory damages on the breach of contract claim. Judge John Speroni awarded \$130 million in compensatory damages for violations of the Illinois Consumer Fraud and Deceptive Business Practices Act in addition to the \$600 million in punitives. The punitive damage award amounts to roughly 150% of what the jury awarded in compensatory damages.

This class action involved State Farm's failure to use factory-authorized automobile parts or original equipment manufacturer "OEM" parts for repairs. The class consisted of vehicle casualty insurance policyholders, except in Arkansas and Tennessee, who between July 28, 1994 and February 23, 1998, had filed a claim for repairs in which State Farm did not use factory-authorized or OEM parts. Evidence was presented at trial that suggested that generic parts consistently ordered by State Farm were of lesser quality.

²⁵ Thompson, Mark, "But Is There Anything to Slow Down?" *ABA Journal*, September 1997.

²⁶ *Id.* See, e.g., *Foremost Insurance Company v. Parham*, No. 1950507 (insurance company found liable for fraud in the sale of mobile homes and related insurance had punitive damages award reduced from \$15 million to \$350,000; See also **Ex Parte Holland**, in which the Court stated that there is a constitutional limit on the amount of punitive damages that may be awarded against a defendant for a tortious course of conduct.

²⁷ 1999 WL 1022134 (Ill. Cir.).

Equally damaging was a 1997 memo written by a State Farm executive stating: “We may well say it is like kind and quality, but the bottom line is that it is not the same.” The breach of contract claim against State Farm was based on State Farm’s failure to restore the cars to their pre-accident condition as promised. Both the court and the jury found that the parts used by State Farm were not of “like kind and quality” and did not restore plaintiffs’ vehicles to their pre-loss condition as required under the policy.

Under Illinois law, claims made under the Illinois Consumer Fraud and Deceptive Business Practices Act are decided by the court, not the jury. The court found that State Farm violated the Consumer Fraud Act. It found that prior to the class action being filed, State Farm knew that the crash parts were not of “like kind and quality” and would not restore their policyholders’ vehicles to “pre-loss conditions.” In determining the amount of punitive damages, the court considered the following factors: (1) the nature and enormity of the wrong, (2) the defendant’s financial status, and (3) defendant’s potential liability in other cases. The court determined that given State Farm’s strong financial condition, it could pay the substantial punitive damages awarded without affecting its ability to pay claims for which it currently provides coverage, without affecting the contractual rights and expectations of its policyholders, and without canceling any of the insurance policies of current policyholders.²⁸ The factors considered by Judge Speroni in determining the amount of punitive awards were based primarily on Illinois law and not on the ruling in **BMW**. However, one of the factors used in **Avery** that is similar to the **BMW** guideposts was the consideration of the defendant’s nature and enormity of the wrong. This is similar to **BMW**’s guidepost of “degree of reprehensibility of the defendant’s conduct.”

State Farm intends to appeal the decision and more specifically the punitive damages on grounds that it constitutes outrageous punitive damages.

2. Recent California cases

California, on the other hand, stands out in the crowd, with the state's appellate justices in no hurry to slash big punitive damage awards. Despite the hope given by the U.S. Supreme Court for some constitutional constraints on huge punitive awards, the promise of those cases remains unfulfilled in California. Over the last two and a half years, California appellate courts have let stand awards of \$11.25 million, \$12 million, and \$21 million. In another case, the Second District Court of Appeal did find that a \$28 million punitive award was excessive -- the Court reduced it to a mere \$15 million. A recent newspaper article²⁹ quotes Michael Matthews, claims counsel for Crum & Forster Insurance, as saying, "If you [believe] that California is bucking a national trend, I think you're absolutely right."

²⁸ *Id.* at 4.

²⁹ "Punitive Awards Thriving on Appeal" *The Recorder*, Tuesday, January 20, 1998, p. 1.

The biggest award so far was in *Paine Webber Real Estate Securities v. Fireman's Fund Insurance Company*³⁰ in which the Court of Appeal upheld a San Francisco jury's punitive award of \$21 million. The jury had found that Fireman's Fund unreasonably refused to contribute \$3 million to Paine Webber's settlement of a suit by Homestead Savings and Loan. The appellate opinion notes that Fireman's Fund's conduct "was especially egregious" because it "completely disregarded the long established law, testimony in the *Homestead* case, evaluation of the attorneys who were present at the trial, evaluation of the primary carrier and its own internal guidelines as to how to conduct an investigation."

As to the amount, the Court wrote, "A ratio of 7:1 between compensatory and punitive damages is well within the acceptable limits. Damages of \$21 million are adequate, but not excessive, to punish a company as wealthy as Fireman's Fund."

In another case, *Mattson Terminals Inc. v. Home Insurance Company*³¹ the jury found that Home Insurance unreasonably refused to pay for \$10.7 million in repairs to the insured's shipping terminal after the 1989 Loma Prieta earthquake. The jury awarded \$11.25 million in punitive damages. In rejecting the excessiveness argument, the Court of Appeal noted that \$11.25 million was "only 1.25 percent Home's net worth of \$900,600,790."³² Interestingly, the courts in both of these decisions focused not only on the ratio between compensatory damages and punitive damages, but also between punitive damages and the wealth or net worth of the defendant.

In March 2000, in an employment-related case venued in Los Angeles County Superior Court, a jury awarded plaintiff Phillip Alexander \$12.5 million in punitive damages. Plaintiff alleged that he was forced out of his job after objecting to alleged unethical practices by the Farmers Insurance Company. This verdict came on the heels of another hit taken by Farmers Insurance Company on February 23, 2000 when a jury awarded former claims adjuster Kermith Sonnier \$9 million in punitive damages for wrongful termination. Mr. Sonnier alleged that Farmers pressured him and other adjusters to low-ball policyholders for claims stemming from the Northridge earthquake. Mr. Sonnier

³⁰ First District Court of Appeal Case No. A063060 (January 1997)

³¹ San Mateo Superior Court Action No. A061211 (October, 1996)

³² See also, *Clayton v. United Services Automobile Association*, 54 Cal.App.4th 1158 (1997) (affirming \$3.9 million in punitive damages for bad faith failure to settle with an insured who had lost his only child in a car accident); and *West American Insurance Company v. Freeman*, 46 Cal.App.4th 1476 (1995) (affirming a \$12 million punitive verdict along with a \$1.3 million compensatory verdict). See also, *Cates Construction v. Talbot Partners*, B085960 and B087801, a March 1997 opinion from the Los Angeles based Second District Court of Appeal in which a judge awarded a developer \$3.1 million for breach of contract. The parties stipulated that actual tort damages were \$1.00. The jury awarded \$28 million in punitive damages against a liability insurer. The appellate court held that the \$28 million was excessive but allowed most of it to stand, reducing the award to a mere \$15 million.

alleged that Farmers fired him after he refused to comply. Farmers intends to appeal both decisions.

There are essentially two theories why such awards are being upheld in California. One is that plaintiff's lawyers are now picking cases more carefully and presenting them with more finesse. The other is that the standard of review is so limited as to make overturning a punitive award difficult. That is, once a punitive award reaches the court of appeal, the court only looks for substantial evidence to support it and lets the jury decide whether or not the burden has been met.

On a final note, in what appears to be a first in the insurance industry, Allstate Insurance Company was awarded \$3 million in compensatory and punitive damages by a federal jury in April 2000. In **Allstate Insurance Company v. Booth**, the insurer claimed that its adjuster Harry Booth, along with an engineering firm and two contractors submitted fraudulent invoices for work not done at ten residential properties. Allstate's attorney James Fitzgerald said the "overwhelming documentation of the fraud" and the fact that the defendants refused to take the stand had the greatest impact on the jury³³. The defendants intend to file motions for a new trial.

V. RECOMMENDATIONS FOR DEFENDING A PUNITIVE DAMAGES CLAIM

Punitive damages claims against insurance carriers must be evaluated from the outset of a case and aggressively defended throughout the litigation. Too often, defendants have lost opportunities to eliminate or reduce punitive damages awarded against them by failing to timely assert available defenses.

The insurer's defense counsel should have three objectives. First, counsel should aggressively defend the fraud or bad faith claim so that the jury will not reach the issue of punitive damages. Second, counsel must elicit all bases of the punitive damages claim so that the insurer is prepared at trial. Third, counsel must preserve objections by protecting the record to enhance the insurer's chances of overturning a punitive damages award on appeal.

A. Choice Of Law

The law on punitive damages varies widely from state to state. Some states restrict punitives; others prohibit them. Some states use punitives to punish; others to deter; others to deter not only the defendant but other potential defendants.³⁴ Table 1 describes the differing philosophies in different states. For this reason, defense counsel must never

³³ "Allstate Wins Damages in Northridge Quake Lawsuit," by Brenda Sandburg, *The Recorder*, Tuesday, April 18, 2000, p.2.

³⁴ See generally 1 **Ghiardi & Kircher, Punitive Damages Law and Practice**, § 4 (1994) [hereinafter cited as 1 **Ghiardi & Kircher**].

concede the application of the forum's law without first evaluating whether another state's law is more favorable.

States also may differ as to the evidence that may be admitted at trial and the guidelines (if any) for review of punitive damages awards. For example, although nearly all jurisdictions allow evidence of the defendant's wealth if other evidence in the case supports the submission of a punitive damages claim to the jury, a few states prohibit introduction of financial information. Other states have statutory requirements regarding the admissibility of the defendant's financial status. For example, the plaintiff may be required to prove a prima facie case for punitive damages. Table 2 summarizes the states' individual positions on the admission of evidence concerning a defendant's financial status.

The different policies and philosophies of states for permitting punitive damages obviously affect the standards for awarding punitive damages at the trial level and for the basis of appeal. The difference in the definition of "oppression" which, along with fraud and malice, is one of the elements generally necessary in order to establish a case for punitive damages, can have a dramatic impact on the jury's final decision. Many states define "oppression" as "the conscious disregard of rights of others." Some trial judges have been known to remark that any time an insurance claim has not been paid, it possibly could constitute a "conscious disregard of the rights of the insured." Such thinking allows the issue of punitive damages to go to the jury in almost every insurance bad faith case. However, in other states such as California the standard is now "despicable conduct." This carries a far more heinous connotation and can often be used to persuade a trial judge that punitive damages are inappropriate as a matter of law.

Different jurisdictions also have different burdens of proof concerning punitive damages.³⁵ In a majority of states, including California,³⁶ the elements to show conduct warranting punitive damages require "clear and convincing proof," as opposed to "preponderance of the evidence" (though some states still employ a preponderance standard). Other jurisdictions such as Colorado allow recovery of punitive damages only upon proof "beyond a reasonable doubt."³⁷

Where choice of law issues (or even different venue possibilities within a jurisdiction) are present, the careful practitioner will examine not only the laws and policies of a jurisdiction, but also the available jury pool and the historical size of punitive damages. The attorney also should be familiar with the tendency of local judges to reduce punitive damage awards and study the competing appellate districts to evaluate their willingness to overturn or reduce punitive damage awards.

³⁵ See *Id.* at §§ 5.01, 9.12.

³⁶ Cal. Civ. Code § 3294(a) (West 1995).

³⁷ 1 **Ghiardi & Kircher**, *supra*, at § 9.12.

B. State Versus Federal Court

Counsel must evaluate the benefits and disadvantages of removing a state action to federal court or remanding a federal action to state court. Federal courts are considered to be faster, less likely to succumb to local influence (a special concern for out-of-state defendants), more receptive to federal claims, and will assign one judge to preside over the entire case. However, federal courts also have limited subject matter jurisdiction and may be restricted by the Seventh Amendment's arguable prohibition of appellate review of a jury's finding.³⁸ Moreover, a federal court may not be obligated to follow a state's **procedures** for bifurcation of punitive issues (discussed more fully below) or a state's rules of evidence.

C. Responsive Pleading

When appropriate, a punitive damages claim should be challenged with the filing of the first pleading. Most courts allow defendants to file motions to strike or dismiss all or portions of a complaint, including punitive damages. Defense counsel should attempt to strike or dismiss punitive claims that are unsupported by specific factual allegations or are impermissible under the law. To enhance a possible procedural due process objection later on, defense counsel should force the plaintiff to plead specific facts at the outset of the case. In other words, if the plaintiff pleads specific facts early on and then later attempts to change or add facts to support punitive damages, the insurer will have a stronger procedural due process challenge based on lack of notice than if the insurer had permitted general, conclusory allegations to remain unchallenged.

Counsel should also make every effort to extricate all named defendants except the company that issued the policy in question. Plaintiff's attorneys frequently name not only the issuing carrier but also the carrier's parent company and other entities in hopes that evidence of greater financial wealth will result in a larger punitive award. Motions to quash, motions to dismiss or motions for summary judgment are some of the available tools for dismissing improper parties.

Otherwise, defense counsel must allege all affirmative defenses applicable to punitive damages. These defenses include any constitutional challenges based on federal and applicable state constitutions. As a few examples, defense counsel might allege:

Plaintiff is not entitled to recover any punitive damages from **Company** as such recovery, if permitted, would violate **Company's** due process rights

³⁸ The Seventh Amendment states: "In suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be presented, and no fact tried by jury, shall be otherwise re-examined in any Court of the United States, than according to the rules of the common law." **U.S. Const.** Art. VII. A few courts have begun to consider whether plaintiffs in federal court can assert the Seventh Amendment as placing a fundamental limit on the power of trial and appellate courts to review jury verdicts. This argument could not be applied in state courts.

under the Fifth Amendment/under the Fourteenth Amendment to the U.S. Constitution.

Plaintiff is not entitled to recover any punitive damages from Company as such recovery, if permitted, would violate **Company's** due process rights under the [state] Constitution. Article ____, Section ____.

Plaintiff is not entitled to recover any punitive damages from **Company** in that the vagueness and uncertainty of criterion for the imposition of punitive damages in such cases undo [state] law and the lack of fair notice of the prohibited conduct resulting from such vagueness and uncertainty violates **Company's** fundamental rights as guaranteed under the federal and [state] constitutions.

Plaintiff is not entitled to recover any punitive damages from **Company** to the extent that such recovery would constitute an impermissible punishment based on **Company's** corporate status and violates the tenets of the Equal Protection clause.

Plaintiff is not entitled to recover any punitive damages from **Company** as such recovery, if permitted, would violate the Excessive Fines Clause of the Eighth Amendment to the U.S. Constitution.*

**Applicable if government may receive share of award.*

Plaintiff is not entitled to recover any punitive damages from **Company** as such recovery, if permitted, would violate the Excessive Fines Clause of the [state] Constitution, contained in Article ____, Section ____.

Plaintiff is not entitled to recover any punitive damages from **Company** to the extent that the law of [state] precludes recovery of punitive damages.

Plaintiff is not entitled to recover any punitive damages from **Company** to the extent that the law of [state] fails to contain a requirement limiting punitive damages to a reasonable proportionality to compensatory damages or to a reasonable proportionality to actual harm done.

Counsel also needs to carefully consider how to respond to allegations of bad faith in the answer. Many jurisdictions will not impose punitive damages on a corporation for acts of lower level employees unless the corporation ratifies the wrongful act.³⁹ In some states, a corporation can be deemed to have ratified a wrongful act if the corporation denies in its answer or other pleading that the conduct was wrongful. Accordingly, where the alleged acts of bad faith were committed by lower level claims personnel, the insurance carrier should carefully consider whether it wishes to deny the acts or deny that the acts were unreasonable. Such denials may act as ratification by the corporation of such acts and

³⁹ Cal. Civ. Code § 3294(b) (West, 1995).

hold the corporation responsible for punitive damages where they otherwise would not be so liable. Obviously, the insurer's failure to deny unreasonableness will bind the corporation on the issue of bad faith, but such a course may be appropriate where there are no defenses to the reasonableness of the act and the entire case centers around whether such acts warrant a punitive damage award and whether the punitive damages based upon the acts of the non-managerial employee can be imputed to the corporation.

D. Discovery

1. Insurer Discovery

TXO is particularly problematic because the Court, including both concurring and dissenting justices, sanctioned the admissibility of extensive evidence on liability and punitive damages. Equally troubling was the Court's affirmance of the West Virginia court's admission of evidence, including evidence of prior bad acts, the potential harm to Alliance, and the potential harm to others, over seemingly valid objections based on hearsay, prejudice and provisions of the criminal evidence code. In short, *TXO* leaves defendants unable to predict with any certainty the scope of admissible evidence at trial. Therefore, discovery is crucial in order to avoid surprise and ambush at trial.

Defense counsel should approach discovery with an objective of eliciting all bases of the plaintiff's claim for punitive damages without alerting the plaintiff to the need for developing evidence to support the claim. For this reason, open-ended, innocuous contention interrogatories should be served periodically throughout the case and always at or near the deadline for the close of discovery. Any effort by the plaintiff to offer evidence at trial that deviates or goes beyond the plaintiff's earlier discovery responses should be resisted with evidentiary and procedural due process objections and perhaps countered with a motion for mistrial if the evidence is admitted. Obviously, defense counsel should secure all documents and depose or interview all witnesses identified by the plaintiff on the punitive damages issue.

At least one commentator has suggested that defense counsel should thoughtfully consider pursuing discovery of plaintiff's own wealth, financial condition, economic power and sophistication when defending a punitive damages claim.⁴⁰ Such evidence can be relevant to determining whether the defendant acted with malice, fraud, oppression or engaged in despicable conduct. While the cases that discuss this concept are generally ones in which the evidence is that the insured is particularly unsophisticated, counsel can certainly argue the same is true where the insured is particularly sophisticated.⁴¹

⁴⁰ See Robert Reeder and Denise Bense's article on "Issues Relating to Punitive Damages and the Decision to Bifurcate," *Mealey's Litigation Report*, Vol. 11, No. 20 (February 25, 1998).

⁴¹ *Id.*; see, e.g., **Dunn v. HOVIC**, 1 F.3d 1371 (3d Cir. 1993); Restatement (Second) of Torts § 908(2). In **Slottow v. American Cas. Co. of Reading**, 10 F.3d 1355 (9th Cir. 1993), the court held that the standard for the award of punitive damages must be applied (More)

Again, defense counsel's overall objective is to elicit the specific basis of the punitive damages claim so that insurer is prepared to: (1) object to or refute the offered evidence at trial, and (2) raise procedural due process objections if the plaintiff offers evidence that is beyond the scope of his discovery responses.

2. Plaintiff's Discovery To Insurer

Plaintiffs will rely on *TXO* and other decisions on punitive damages to conduct extremely broad discovery against an insurance company. For example, the possible admission of evidence of prior "bad acts" will further induce plaintiffs' attorneys to press for discovery of other insurance claims files, information about other insurance coverage litigation, and policyholder complaints to insurance commissioners and insurance regulatory agencies. Likewise, plaintiffs' attorneys are likely to rely on the admissibility in *TXO* of financial information concerning USX Corporation, TXO's parent, to seek access to extensive financial information about parent companies, subsidiaries and affiliated companies. However, there are some tools which defense counsel can use to resist these discovery attempts.

First, many states, such as California, have statutory limitations on the discoverability of the defendant's financial information. These statutes usually prohibit discovery beyond the mere identification of witnesses and documents unless and until the court, upon motion and after a hearing, finds there is a "substantial probability" that the plaintiff will prevail on the fraud claim.⁴²

Defense counsel, of course, must assert any statutory prohibitions against premature discovery of information concerning an insurer's financial condition or other issues relating to punitive damages. Even when the forum does not provide any statutory limitations on discovery, defense counsel should resist any discovery on the punitive damages issue on the ground that the plaintiff first must establish a prima facie case of fraud before gaining access to highly sensitive, confidential, and proprietary information.

"in light of the relative economic power, sophistication and legal expertise of the parties" See, **Grynberg v. Citation Oil & Gas Corp.**, 1977 WL 6781712 (S.D.) (In reducing \$4.8 million punitive damage award to \$1 million, the court found the expertise and sophistication of plaintiffs as worthy of note in considering the nature and enormity of the wrong.) See, also, **Schaffer v. Edward D. Jones & Co.**, 521 N.W.2d 921 (S.D. 1994) (A factor in upholding substantial punitive damage award was the deceit of brokerage firm in selling securities to plaintiff, who was a farmer with an eighth grade education and unsophisticated in these types of investments.); **Davis v. Merrill Lynch, Pierce, Fenner & Smith**, 906 F.2d 1206, 1210 (8th Cir. 1992) (applying South Dakota law) (affirming a \$2 million punitive damage award to an "unsophisticated investor who completely trusted [her broker] and relied upon his advice").

⁴² Cal. Civ. Code §§ 3294, 3295 (West 1995). For a comprehensive discussion of how different states view this issue, see McLoughlin, James, "Necessity of Determination or Showing of Liability for Punitive Damages before Discovery or Reception of Evidence of Defendant's Wealth," 32 ALR 4th 432.

Second, if ordered to produce financial information, defense counsel always should attempt to limit the production to financial information solely concerning the specific company which is a party to the litigation. If the party is a subsidiary and the plaintiff moves to compel production of financial information on the parent or other parent companies, defense counsel should distinguish *TXO* by submitting affidavits proving that the subsidiary is solvent and in compliance with state financial regulations. In other words, because subsidiaries will be solvent, fully capitalized insurers, it would be unnecessary and prejudicial to permit the jury to consider financial information of the parent or related entities. Defense counsel should limit the production to publicly available financial statements.

Third, in cases where the court has or will order an insurer to produce sensitive information, defense counsel always should attempt to limit the production as narrowly as possible. For example, in a bad faith, fraud action against an insurer arising out of the claims handling of one employee, discoverable evidence of similar, prior "bad acts" should be limited to claims handled by the same employee.

Finally, if required to produce sensitive information, defense counsel always should seek a protective order which seals the documents and limits disclosure to specific individuals in the specific litigation.

E. Pre-Trial Motions

1. Dispositive Motions

Whenever possible, defense counsel should file a dispositive motion for judgment on the pleadings, summary judgment, or summary adjudication of issues on the punitive damage count. Although dismissal of the punitive damage claim is the obvious objective, even an unsuccessful dispositive motion often will force the plaintiff to expose his evidence and theories. Again, the objectives are to elicit specific facts to avoid surprise at trial and to create an extensive and clear record of insurer's objections.

2. Motion To Bifurcate

In many states (such as California, Georgia, New Jersey, and Mississippi), the Code of Civil Procedure automatically bifurcates the liability and punitive phases of a trial upon request of a party. In those states, evidence on punitive damages is inadmissible unless the jury returns a plaintiff's verdict entitling the plaintiff to punitive damages. If the jury returns a plaintiff verdict, the parties then try the punitive damages phase to the same jury.

Connecticut, Illinois, Louisiana, and Wisconsin have statutes which bifurcate separate causes of action or claims but not separate issues. Other states have no statutory provisions for bifurcation; instead, bifurcation and severance of claims and issues lie within the inherent authority of the trial court. Similarly, in federal court, the trial court may sever or bifurcate issues for trial pursuant to Rule 42(b). When an insurer has been sued in federal court or in a jurisdiction which does not automatically bifurcate liability

and punitive issues, defense counsel should move to bifurcate or sever trial of the liability and punitive issues as early as possible.⁴³

F. Preparing Insurer's Defense

An insurer must make important tactical decisions long before trial. The Federal Rules of Civil Procedure and an increasing number of states require parties to designate before trial all witnesses and documents the party intends to offer at trial. If a party fails to designate a witness or document prior to trial, a federal court may not admit the document or allow the witness to testify.

Early disclosure of witnesses and documents will help avoid surprise at trial. On the other hand, if an insurer discloses a witness or document concerning an issue on which the plaintiff is unprepared, the insurer risks tipping-off the plaintiff and jeopardizing its defense. Below, we discuss some of these tactical issues.

1. What Is "Net Worth"?

Many state statutes which allow evidence of defendants' wealth do not specify what information should be allowed for purposes of determining an insurer's "financial condition." Courts utilized the term "net worth" to describe wealth or financial condition, but the term has not been clearly defined. To the contrary, "net worth" is recognized as being "a misleading term, to be avoided."⁴⁴

Assuming a punitive damages award may not be disproportionate to the defendants' financial condition, the appropriate measure of that financial condition is critical. Courts have permitted a wide variety of evidence to determine a defendants' financial condition for purposes of assessing punitive damages.⁴⁵ Defense counsel should be prepared to

⁴³ For an excellent discussion of issues relating to punitive damages and bifurcation, see a series of three articles by Robert R. Reeder and Denise B. Bense in *Mealey's Litigation Report*, Vol. 11, Nos. 18, 20 and 22, published in January, February and March 1998.

⁴⁴ *Id.*; *Financial Accounting, An Introduction to Concepts and Methods and Uses*, 7th Ed. 1994 by Clyde P. Stickney and Roman L. Weil, Glossary, p. G-61; Comment: "Discovery of Net Worth in Bifurcated Punitive Damages Cases: A Suggested Approach after **Transportation Insurance Company v. Moriel**", 37 S.Tex. L.Rev. 193, fn. 109 (January 1996). See, **Lunsford v. Morris**, 746 S.W.2d 471 (Tx. 1988); **Herman v. Sunshine Chemical Corp.** 627 A.2d 1081 (N.J. 1993); **Zazu Designs v. L'Oreal, S.A.**, 979 F.2d 499, 508 (7th Cir. 1992).

⁴⁵ See, e.g., **Miller v. Elite Ins. Co.**, 100 Cal.App.3d 739, 161 Cal.Rptr. 322 (1980) (net assets); **Walker v. Signal Companies, Inc.**, 84 Cal.App.3d 982, 149 Cal.Rptr. 119 (1978) (gross assets); **Little v. Stuyvesant Life Ins. Co.**, 67 Cal.App.3d 451, 136 Cal.Rptr. 653 (1977) (net assets); **Roemer v. Retail Credit Co.**, 44 Cal.App.3d 926, 119 Cal.Rptr. 82 (1975) (net worth and after tax income); **Dunn v. HOVIC**, *supra*. (net income) fn.4; **Vasbinder v. Scott**, 976 F.2d at 121 (net income); **Davis v. Merrill** (More)

argue that an insurer's net worth should be measured solely by its unrestricted or unassigned funds, which are not earmarked for the benefit of policyholders and/or stockholders.⁴⁶

2. Testimony Of Corporate Officers or Experts on Net Worth

In cases where the financial status of the insurer becomes relevant either because motions to bifurcate were denied or the liability portion of a case has been lost, the insurer must decide how evidence of its financial status will be presented to the jury. If practical, it is almost always preferable to have a high-ranking corporate officer testify about the net worth of the company. Because the issue (and many times the **sole** issue) to be decided by the jury is the amount to punish the company, a personification of the company in the form of a corporate officer humanizes the company and demonstrates that the jury's message will be heard in the boardroom and will take some of the sting out of the plaintiff's counsel's closing argument that the award must be large enough to send a message back to home office. It may also bring home the idea that punitive damages should punish--but not destroy or bankrupt--the defendant and ensure that the punitive award is not too large.

However, the use of a corporate officer to testify about the net worth is not without dangers, particularly where the case involves a company subsidiary. Because officers of subsidiaries almost always are officers of the parent company, counsel risk exposing information about the parent and its net worth during cross-examination of the subsidiary's (and parent's) corporate officer. This danger can be eliminated where the court rules on motions in limine or otherwise that the jury may not hear evidence of the parent's net worth, a corporate officer could testify at trial without risking opening the door on cross-examination. Otherwise, defense counsel probably should not call an officer and instead rely on expert testimony.

3. Experts

Because the primary focus on the amount of the punitive damages award in most states is the financial condition of the defendant, an insurer should consider retaining one or a few experts on a nationwide basis to consult with defense counsel and testify during punitive

Lynch, Pierch, Fenner & Smith, 906 F.2d 1206, 1225 (8th Cir. 1992) (applying South Dakota law) (net income); and **Herman v. Sunshine Chemical Specialties, Inc.**, 627 A.2d 1081, 1089 (N.J. 1993) (defendant's income) citing Robert W. Hamilton, *Fundamentals of Modern Business* § 11.5 to .8 (1989) and refe *Punitive Damages: Law and Practice* referencing 1 James D. Ghiardi & John J. Kircher, § 5.36, at 50 (1985) ("Net income is the best yardstick for determining punitive damages.")

⁴⁶ **Palmetto Federal Savings Bank of South Carolina v. Industrial Valley Title Insurance Company** 756 F.Supp. 925, 936 (Dsc. 1991) court referred to insurer's "surplus" of less than \$6 million in determining punitive damages award of \$100,000); **Cock-N-Bull Steak House v. Generali Ins. Co.** 466 S.E.2d 727, 731 (S.C. 1996) (expert allowed to testify as to existence and purpose of surplus accounts).

damages trials. As discussed above, there may be times when it is tactically disadvantageous to have a corporate officer testify concerning the financial condition of the company. Furthermore, it may be impractical to have the corporate officer prepared and available to testify, particularly where the punitive damage phase of the trial falls immediately after the unpredictable amount of jury deliberations on the liability portion of the trial.

Even where counsel will have a corporate officer testify to the financial condition of the company, these accounting experts would assist defense counsel in determining the range and scope of financial information to produce to the plaintiff. The accounting experts will testify during punitive damages trials about accounting procedures used by insurance companies in general and, in particular, the financial statements of the defendant insurer or its applicable subsidiary. Where appropriate, the expert would testify about Capital and Surplus Accounts, Risk-Based Capital, the Combined Ratio, the Net Operating Ratio, the ratio of premiums to surplus, and so on, in an effort to either minimize the company's net worth in the eyes of the jury or to convince the jury that insurer's net worth should remain intact for the benefit of its future policyholders and other claimants.

An insurer also should consider engaging an accountant or economist in appropriate cases to refute testimony about the harm to the plaintiff or others that would have been caused by the wrongful conduct. For example, in *TXO*, Alliance argued before the U.S. Supreme Court that had TXO accomplished its fraud, Alliance would have been damaged by \$5 million to \$8 million. We can expect that in some cases, particularly cases with low compensatory damages, creative plaintiffs' attorneys will engage experts to testify about the "enormous" magnitude of potential harm created by an insurer's misconduct. Although defense counsel should object to the admissibility of **any** expert testimony on this issue, counsel should be prepared to refute the plaintiff's evidence if the court admits expert testimony.

4. Developing Evidence Of "Good" Acts

In *TXO*, the trial court admitted evidence of prior bad acts to prove "malice," one of the elements of slander of title. Although the U.S. Supreme Court impliedly approved of the jury's consideration of prior bad acts in calculating punitive damages, it is unclear whether the court would sanction the admission of "bad act" evidence in the punitive phase of a bifurcated trial.

In any event, an insurer should develop evidence of its "good acts" with two objectives. The first objective is to refute admissible evidence of "bad acts" with evidence that, for example, the insurer has paid substantial claims, that insurer has responded quickly and humanely to natural disasters, that the insurer has contributed to charity, that the insurer's officers and employees participate in charitable functions, and so on.

The second and more realistic objective of developing evidence of "good acts" is to persuade the trial judge to exclude **all** evidence of prior, similar conduct, whether good or bad. In other words, if defense counsel makes an offer of proof of, hypothetically, three to four weeks of testimony and evidence of all of the insurer's benevolent acts, the court

may exclude any evidence of prior acts to shorten the trial. On the other hand, if the court permits evidence of prior "bad acts" but limits the insurer's testimony or evidence, the insurer has protected the record and created a constitutional objection to any punitive damages award.

G. Trial Issues

1. Motions In Limine

Defense counsel should file motions in limine directed to the punitive damages claim. Defense counsel should move in limine to exclude prejudicial evidence, such as evidence of alleged prior or similar misconduct. If the liability and punitive phases are not bifurcated, counsel should move in limine to exclude references to the insurer's net worth until after the plaintiff establishes a prima facie case.

Defense counsel always should move in limine to limit evidence of financial information to the particular subsidiary as opposed to the parent and to limit the cross-examination of a corporate officer to topics concerning that specific subsidiary rather than the corporate parent.

If previously unsuccessful, defense counsel should renew motions to sever or bifurcate the punitive damages issues from the liability trial. Counsel also should renew constitutional attacks on the vagueness and ambiguity of any applicable fraud standard or statute on punitive damages.

As a result of the *BMW* decision, defense counsel should give consideration to submission of two additional punitive damage specific motions in limine. First, counsel should consider moving to exclude evidence of similar conduct by the insurer in other jurisdictions. Such a motion is supported by the *BMW* Court's reiteration that one state may not punish a defendant for conduct in other states which is legal under the other states' law. Second, counsel should consider filing a motion to prohibit the plaintiff from requesting or mentioning punitive damages in excess of potential sanctions under the particular states' insurance regulatory scheme. This dovetails with the *BMW* Court's pronouncement that such statutes provide a guidepost for the propriety of a punitive damage award.

2. Voir Dire and Jury Selection

The factors involved in voir dire and jury selection (more properly, de-selection) to avoid or minimize punitive damages are too varied and complex to discuss here. However, counsel should conduct voir dire and use peremptory challenges with the concept of punitive damages firmly in mind. Counsel will obviously want to avoid particularly judgmental individuals and those who are likely to want to seek harsh penalties. However, counsel might want to avoid asking the ultimate question concerning feelings towards punitive damages, because it risks exposing counsel's "keeps" who have strong views against the imposition of such punitive damages.

3. Liability Trial

As mentioned earlier, the strongest defense to a punitive damage claim is to prevail on the issues of bad faith, fraud, oppression, or malice. However, in all but the most unusual cases, in closing argument defense counsel must cover a plaintiff's claim for punitive damages. While argument against punitive damages may seem defensive where the claim is being defended on all issues, including coverage and bad faith, most experienced trial lawyers know techniques to minimize the negative impact. For example, defense counsel can explain that although he or she does not personally believe that the jury will ever reach the issue of punitive damages, he or she has an obligation to their client to fully cover and argue all points during closing argument. Alternatively, a plaintiff's claim for punitive damages can be a further example of overreaching or set-up by plaintiffs and their counsel.

In any event, it generally is simply too dangerous to ignore the issue of punitive damages during closing argument. It is important to provide the jury with arguments they can use during deliberation on why the insurer's conduct was not fraudulent, malicious or oppressive. The common technique is to emphasize that the claims decisions were made by individuals (who hopefully were there during trial and closing argument) and that while reasonable minds might differ as to the correctness or even the reasonableness of their claims handling and decisions, the plaintiff has not shown how these individuals are frauds or committed despicable conduct.

Throughout the trial, defense counsel must object, either in or outside the jury's presence as appropriate, to any prejudicial statements or testimony about the insurer which might tend to increase a punitive damages award. Defense counsel, whenever possible, should move for non-suit and, if unsuccessful, for motion for directed verdict, at least as to the punitive damage count.

4. Jury Instructions

Jury instructions are exceedingly important. One may think that jurors do not consider jury instructions to be important, but appellate courts examine them very carefully. Defense counsel should not accept standardized, vague instructions on fraud or punitive damages. Defense counsel should draft and propose specific, narrow instructions to ensure that the jury does not consider status, large net worth, or other inflammatory factors. If net worth evidence is admitted, counsel should request an instruction that wealth is relevant only to ensure that the award of punitive damages is not too large and cannot be used to increase the amount of the award. Drafting instructions are recommended to the effect that the jury cannot consider certain evidence that may have been admitted over the insurer's objection. Defense counsel must record objections to plaintiff's proposed instructions or the court's modification of instructions proposed by the defense.

5. Punitive Phase Of The Trial

The insurer should consider associating "punitive" defense counsel in **serious** fraud cases, just as criminal defendants in capital punishment cases retain separate counsel to

argue the sentencing phase of the case following conviction. In short, if the jury has found the insurer liable for fraud, the jury will be predisposed against the insurer and its defense counsel during the punitive phase of the case.

During the punitive phase of the case, the plaintiff's attorney will argue the reprehensibility of the defendant's conduct, and in most jurisdictions, will introduce evidence of the defendant's net worth.

Typically, the plaintiff's attorney will ask the jury to award an amount of punitive damages equal to some percentage of the insurer's net worth, which is usually described on financial statements as policyholder surplus. Because many insurer's financial statements reflect a policyholder surplus of hundreds of millions of dollars, an award of even a small percentage of surplus, such as 1%, can constitute a staggering amount. The plaintiff's attorney will request an award sufficient to "send a message to home office..." to punish the company and guarantee deterrence of similar wrongful conduct in the future.

Through the testimony of corporate witnesses and experts, defense counsel must minimize the company's net worth in the eyes of the jury. It is imperative to educate the jury that the insurer's assets should be preserved for future claims by other policyholders, as well as contingencies, such as the many recent natural disasters and catastrophes which have hit the nation in the insurance industry.

A high level corporate officer is best suited to testify about the insurer's business and financial position. The presence of a corporate officer demonstrates the insurer's concern and responsiveness and may lessen the juror's perceived need to send a "message to home office." Where applicable, the corporate officer can describe any remedial measures or policies the insurer has implemented in order to prevent similar misconduct from happening again. In other words, the jury does not need to award damages to deter future misconduct if the insurer has already taken steps to prevent similar misconduct in the future.

A comprehensive discussion of the presentation of financial information through corporate officers and experts is beyond the scope of this presentation. The defense, however, should focus on any downward or negative trends in the financial statements whenever possible. Testimony concerning extensive insurance regulations, which require adequate capitalization and surplus, and testimony concerning various net operation ratios can effectively counter the plaintiff's attorneys arguments about the defendant's massive wealth. The company's net worth may look small when divided by the total number of existing policyholders, who all represent potential claimants. Additionally, the defense should address the negative impact a reduction of surplus would have on the company's ability to generate premiums.

Even when a finding of fraud, oppression or malice is unlikely, counsel must prepare extensively for the punitive aspect of the case. Insurers should consider grooming one or more designated, "most knowledgeable" corporate officers to testify about the company's business and financial position.

H. Post-Trial

If a large punitive damage award is returned by the jury, defense counsel should ask for a stay of execution pending post-trial motions. Defense counsel must file appropriate motions for judgment notwithstanding the verdict and for a new trial. Defense counsel also should seek de novo review of the punitive damages phase of the trial by the trial judge and reviewing courts. Counsel should also consider associating in appellate counsel to raise all appropriate constitutional objections.

I. Arbitration Proceedings

An arbitrator's authority to award punitive damages depends on the law of the jurisdiction under which the arbitration takes place. Those jurisdictions which have considered the issue generally fall into three categories. The first, led by the federal courts, empowers arbitrators to award punitive damages as part of the arbitrator's ability to award complete relief, unless the arbitration agreement states otherwise.⁴⁷ The second views punitive damages awards as a sanction reserved to the state, and thus an arbitrator possesses no power to award punitive damages regardless of the parties' agreement.⁴⁸ Finally, the third

⁴⁷ See, e.g., **Raytheon Co. v. Automated Business Systems, Inc.**, 882 F.2d 6 (1st Cir. 1989); **Regina Construction Corp. v. Envirmech Contracting Corp.**, 80 Md. App. 662, 565 A.2d 693 (1989); **Bonar v. Dean Witter Reynolds, Inc.**, 835 F.2d 1378 (11th Cir. 1988); **Todd Shipyards Corp. v. Cunard Line, Ltd.**, 943 F.2d 1056 (9th Cir. 1991); cf. **Thomson McKinnon Securities, Inc. v. Cucchiella**, 32 Mass. App. Ct. 698, 594 N.E.2d 870 (1992).

These cases involved the punitive damages issue with regard to arbitration agreements incorporating by reference the rules of either the Federal Arbitration Act, the American Arbitration Act, or the New York Stock Exchange. Although not necessarily applicable to bad faith claims filed against an insurer, the issue of a punitive damages award in an arbitration proceeding governed by the FAA rules has been addressed. In **Helco Petroleum Corp. v. AIG Oil Rig, Inc.**, 565 N.Y.S.2d 776 (1991), a case involving a bad faith action filed by an insured against its insurers, the New York Supreme Court found that a common law right to punitive damages against an insurance company for conduct amounting to an unfair claim settlement practice was not preempted by statute (here, Insurance Law § 2961). However, **Helco** was decided in New York, a jurisdiction which prohibited punitive damages in arbitration awards. Because the arbitrator lacked authority to award punitive damages, its determination on the bad faith issue was not res judicata on the punitive damages issue facing the court.

The appellants in a footnote to their brief also argued that, notwithstanding the policy against punitive damages in arbitration proceedings, their arbitration was governed by the FAA, under which arbitrators have the power to award punitive damages. The court refused to accept this interpretation, particularly because the contract contained a choice-of-law provision designating New York law.

⁴⁸ See, e.g., **Garrity v. Lyle Stuart, Inc.**, 353 N.E.2d 793 (1976), and **Board of Educ. v. Niagara-Wheatfield Teachers Assoc.**, 389 N.E.2d 104 (1979) (New York); **United States Fidelity & Guaranty v. DeFluiter**, 456 N.E.2d 429 (1983) (Indiana); (More)

category has adopted the position that an arbitrator may award punitive damages only when the parties to the arbitration agreement authorize such relief by express provision or pursuant to a stipulated submission.⁴⁹

Of course, individual states provide their respective statutory means by which a court may review and vacate an arbitration award. For example, California Code of Civil Procedure § 1286.6 states an arbitration award shall be corrected if there is an evident miscalculation or mistake, if the arbitrator exceeded his or her authority but the award could be corrected without affecting the merits of the decision, or if the award was imperfect in form. Section 1286.2 sets forth five specific grounds for vacation of an award: (1) procurement of an award by corruption, fraud, or other undue means; (2) a corrupt arbitrator; (3) the arbitrator's misconduct substantially prejudiced a party's rights; (4) the arbitrator exceeded his or her authority and the award cannot be corrected without affecting the merits of the decision; and (5) the arbitrator's refusal to postpone the hearing upon a showing of sufficient cause, to hear material evidence, or other conduct substantially prejudiced a party's rights.

In addition to attacking the punitive damages portion of an award on statutory grounds, an arbitrator's award may be challenged as a due process violation. Such claims may be based on lack of notice that punitive damages could be included in an arbitration award. However, these allegations generally are not successful. "Notice" is adequate if a clause in the parties' agreement is sufficiently broad to encompass a punitive damages award,⁵⁰ as are clauses which clearly seem to contemplate a wide range of tort and contract claims.⁵¹

Due process claims based on the lack of procedural safeguards resulting in arbitrary and capricious punitive damages awards also generally do not prevail. In *J. Alexander Securities, Inc. v. Mendez*,⁵² the California Court of Appeal rejected the appellant's claim that the absence of constraints on arbitrators in awarding punitive damages and lack of judicial review constituted a denial of its due process rights. The court found the

Rifkind & Sterling, Inc. v. Rifkind, 28 Cal. App. 4th 1282, 33 Cal. Rptr. 2d 828 (1994) (California).

⁴⁹ **Edward Electric Co. v. Automation, Inc.**, 593 N.E.2d 833, 229 Ill. App. 3d 89 (1992) (Illinois); **Complete Interiors, Inc. v. Behan**, 558 So.2d 48 (1990) (Florida); **Kline v. O'Quinn**, 874 S.2. 2d 776 (1994) (Texas).

⁵⁰ See, e.g., **Raytheon**, 882 F.2d at 7 ("All disputes arising in connection with the Agreement shall be settled by arbitration"); **Willoughby Roofing & Supply Co. v. Kajima International, Inc.**, 598 F. Supp. 353, 355 (D. Alaska 1984), *aff'd*, 776 F.2d 269 (11th Cir. 1985) ("All claims, disputes, and other matters in question arising out of, or relating to, this Agreement or Work Assignment or the breach thereof . . . shall be resolved by arbitration").

⁵¹ **J. Alexander Securities, Inc. v. Mendez**, 17 Cal. App.4th 1083, 21 Cal.Rptr.2d 826 (1993) ("[A]ll other disputes or controversies between [the parties] arising out of [appellant's] business or this agreement.).

⁵² *Id.*

appellant had failed to allege any facts to support its contention that the arbitrators had acted arbitrarily and did not claim it was precluded from presenting any evidence or legal theories militating against a punitive award. Further, a panel of three arbitrators, selected by the parties, had presided over the dispute and were less likely than a jury to be swayed by prejudice and passion. Finally, the court noted California already had addressed the lack of judicial review of punitive damages arbitration awards in *Baker v. Sadick*,⁵³ which determined the parties to an arbitration agreement had the power to control the scope of arbitration by that agreement and thus were not harmed.⁵⁴

VI. CONCLUSION

Although punitive damages pose a serious threat to insurance companies defending allegations of bad faith, knowledgeable defense counsel can and should assert all appropriate defenses beginning with the first responsive pleading. While the Supreme Court has not provided defendants with the kind of protection desired, recent decisions have demonstrated the need to raise and preserve every procedural and substantive defense throughout the litigation. The preservation of these constitutional defenses coupled with aggressive trial defense should allow insurance carriers to defend bad faith litigation without unnecessary concern for staggering, company-threatening punitive damages awards.

⁵³ 162 Cal. App. 3d 618, 208 Cal. Rptr. 676 (1984).

⁵⁴ See also *Todd Shipyards*, *supra*, at 1064 ("[Appellant] had every opportunity to present evidence, to argue the merits of its position, and to challenge the arbitrator's award in court. Having taken advantage of this process, into which it entered voluntarily, [appellant] cannot now argue that its due process was denied."); *Rifkind*, *supra*, (Court held due process guarantees did not control private arbitration agreements, and judicial enforcement of awards did not necessarily include judicial review.).