MAYER, BROWN, ROWE & MAW'S
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Today the Supreme Court granted certiorari in two cases of potential interest to the business community. Amicus briefs in support of the petitioners are due on Tuesday, June 5, 2003, and amicus briefs in support of the respondents are due on Monday, July 7, 2003.[*] Any questions about these cases should be directed to Miriam Nemetz (202-263-3253) or Robert Bronston (202-263-3244) in our Washington office.

In this issue, we also include a detailed analysis of the Supreme Court's opinion in *State Farm Mutual Automobile Insurance Co.* v. *Campbell*, a landmark decision regarding the administration of punitive damages.

1. ***Age Discrimination in Employment Act — Reverse Discrimination.*** The Age Discrimination in Employment Act of 1967 ("ADEA"), 29 U.S.C. §§ 621-634, makes it unlawful for an employer to discriminate against any employee age forty or over on the basis of age. The Supreme Court granted certiorari in *General Dynamics Land Systems, Inc.* v. *Cline,* No. 02-1080, to decide whether the ADEA permits workers who are at least forty years old to challenge as discriminatory employment decisions favoring older workers.

In 1997, General Dynamics Land Systems, Inc. ("General Dynamics") entered into a new collective bargaining agreement with the United Auto Workers. While the prior agreement provided full health care benefits to all employees who retired after thirty years, the new agreement limited such benefits to employees who reached the age of fifty by July 1, 1997. Dennis Cline, on behalf of a class of present and former employees who were at least forty but not yet fifty years old on July 1, 1997, sued General Dynamics under the ADEA, alleging that the new agreement's limitation of retiree health care benefits to employees over fifty constituted unlawful age discrimination. The district court granted General Dynamics's motion to dismiss, holding that the ADEA does not create a cause of action for discrimination against younger employees in favor of older ones.

A divided panel of the Sixth Circuit reversed. 296 F.3d 466 (2002). Relying on the plain language of the statute, the majority concluded that the ADEA makes it unlawful to base employment decisions on chronological age, when those decisions affect workers older than forty. *Id.* at 469. The court also noted that the Equal Employment Opportunity Commission had

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[*] If the Court sets the deadline for the respondents' briefs under the revisions to its rules that go into effect on May 1, 2003, then briefs in support of the respondents will be due on Thursday, July 10, 2003.

promulgated a regulation interpreting the ADEA to bar reverse discrimination against individuals over forty. *Id.* at 471.

The court of appeals acknowledged that its holding was contrary to the "majority of courts to consider the question." *Id.* at 470. Rejecting the reasoning of these opinions, the court refused to give weight to the ADEA's statement of purpose, which explains that Congress enacted the ADEA to protect "older workers" and "older persons" "relative to the younger ages." 29 U.S.C. §§ 621(a)(1)-(3).

This case is of obvious interest to all employers covered by the ADEA. The Supreme Court's adoption of the Sixth Circuit's approach would call into question all company policies that benefit older workers but do not extend to all workers over forty.

2. *Securities Act — Subject Matter Jurisdiction — Coverage of Fixed-Return Sale-Leaseback Contract as Investment Contract*. The definition of "security" under the Securities Act of 1933 and the Securities Exchange Act of 1934 includes not only conventional securities, such as stocks and bonds, but also "investment contracts." The Supreme Court granted certiorari in *SEC* v. *Edwards*, No. 02-1196, to decide whether a sale-leaseback arrangement constitutes an investment contract where the return to investors is fixed, rather than variable, or the investor is contractually entitled to a particular amount or rate of return.

Edwards is the founder and sole owner of ETS Payphones, Inc., a Georgia corporation that sold pay telephones to investors, who then leased the phones back to ETS for five years at a fixed monthly fee, regardless of their profitability. As part of the lease agreement, ETS promised to refund the full purchase price of each payphone at the end of the lease or within 180 days of the investor's request. Alternatively, if an investor was not satisfied with the arrangement, it could cancel the lease and repossess the telephone without penalty. In September 2000, ETS filed for bankruptcy and consequently stopped making lease payments to telephone owners and ceased honoring the buyback guarantees.

The SEC sued ETS and Edwards in the United States District Court for the Northern District of Georgia, alleging that Edwards's business venture was a "massive ponzi scheme," in which ETS was able to honor its obligation to investors only by using money from new investors. The SEC alleged that ETS violated the registration requirements of Sections 5(a) and (c) of the Securities Act, the antifraud provisions of Section 17(a) of the Securities Act, and Section 10(b) of the Exchange Act. At the outset of the case, the SEC sought a preliminary injunction and a freeze of Edwards's assets.

The district court granted the preliminary relief requested by the SEC. 123 F. Supp. 2d 1349. To determine whether the sale-leaseback arrangement was an investment contract under the Securities Act, it applied the three-part test of *SEC* v. *W.J. Howey Co.*, 328 U.S. 293 (1946), which defined an investment contract as a contract, transaction, or scheme whereby a person (1) invests money (2) in a common enterprise and (3) is led to expect profits solely from the efforts of others. Focusing on the last two elements, the district court concluded that investors shared a common enterprise with ETS because "the fortunes of the investors were linked to the efficacy

of the promoter" (123 F. Supp. 2d at 1353), and that the investors expected profits from the efforts of ETS because "[a]ny control that [investors] may have retained was 'illusory' or 'insubstantial' because Defendants assumed all responsibility for the pay phones." *Id.*

The Eleventh Circuit reversed, directing the district court to dismiss the SEC's complaint for lack of subject matter jurisdiction. 300 F.3d 1281 (2002). The court focused on the third element of the *Howey* test, finding for two reasons that investors did not expect profits solely from the efforts of ETS. First, the court reasoned that "'profits' require either a participation in earnings by the investor or capital appreciation." *Id.* at 1284. Capital appreciation was not at issue, and the court found that "the fixed lease payments paid to owners of the telephones could not be considered participation in earnings." *Id.* "Because the investors received a fixed monthly sum, the actual earnings of the telephone, or ETS, were irrelevant." *Id.* at 1285. Second, the court found that "[b]ecause their returns were contractually guaranteed, those returns were not derived from the efforts of Edwards or anyone else at ETS; rather, they were derived as the benefit of the investors' bargain under the contract." *Id.* Because the arrangement was not an investment contract under the *Howey* test, the court of appeals concluded, the district court did not have subject matter jurisdiction under the federal securities laws.

This case is of great significance to businesses that provide packaged sale-leaseback investment opportunities, and to others whose investment contracts might be structured as contractually-guaranteed fixed payments, because an affirmance would limit the jurisdiction of the SEC and possibly state regulators over those investments. On the other hand, investment companies whose investments are already regulated under the Securities and Exchange Acts and who compete for capital with companies that provide such investment contracts may wish to support an interpretation of the Securities and Exchange Acts that extends coverage to contracts of this nature.

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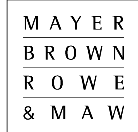
The Supreme Court has requested the views of the Solicitor General in the following cases of interest to the business community:

Central Laborers' Pension Fund v. *Heinz*, No. 02-891: The question presented is whether, when an ERISA pension plan is amended to expand the categories of "disqualifying" post-retirement employment that "suspend" early retirement benefits under the plan, it violates ERISA's anticutback rule (29 U.S.C. § 1054(g)) to apply that amendment to plan participants who had already retired, were already receiving benefits, and were already working in forms of post-retirement employment that were non-disqualifying under the plan but were disqualifying under the amendment. Mayer, Brown, Rowe & Maw represents the respondent.

Cooper Industries, Inc. v. *Aviall Servs., Inc.*, No. 02-1192: The question presented is whether a private party who has not been subject to a civil action under CERCLA may bring an action seeking contribution pursuant to CERCLA Section 113(f)(1) to recover costs spent voluntarily to clean up properties contaminated by hazardous substances.



Norfolk Southern Railway Co. v. *James N. Kirby PTY Ltd.*, No. 01-1028: The questions presented are: (1) whether a cargo owner that contracts with a freight forwarder for the transportation of goods to a destination in the United States is bound by the contracts that the freight forwarder makes with carriers to provide that transportation; and (2) whether federal maritime law requires that the terms of bills of lading extending liability limitations under the Carriage of Goods By Sea Act ("COGSA") to "independent contractors" used to perform a contract of transportation, or whether COGSA must be narrowly construed to cover only those independent contractors in privity of contract with the bill's issuer.

Green Fire Marine Ins. Co. v. *M/V Hyundai Liberty*, No. 02-815: The question presented is whether the court of appeals erred in holding that non-vessel-operating common carriers are, in general, agents for the cargo's owner when they contract for regulated transportation with ocean common carriers and, as such, may bind the owner to a forum selection clause in a contract for the carriage of goods.

ANALYSIS OF SUPREME COURT=S DECISION IN *STATE FARM* v. *CAMPBELL*

On April 7, the Court released its much-anticipated decision in *State Farm Mutual Automobile Insurance Co.* v. *Campbell,* No. 01-1289, in which it provided important new guidance on the administration of punitive damages. Mayer, Brown, Rowe & Maw authored the amicus brief for the Chamber of Commerce of the United States in the case. As a service to our readers, we explore some of the more significant implications of the decision.

Factual and Procedural Background

The case arose out of an automobile accident allegedly caused by State Farm's policyholder, Curtis Campbell. The driver of one vehicle was killed and the driver of another was seriously injured. The injured driver and the estate of the deceased driver each sued Campbell, claiming that his unsafe effort to pass several vehicles caused the accident. Both plaintiffs offered to settle within policy limits, but State Farm rejected the offers and litigated the case. Each plaintiff received an award against Campbell that exceeded his policy limits. After State Farm declined to bond the portion of the judgment that exceeded the limits, Campbell assigned to the plaintiffs and their lawyers a 90% interest in his potential bad faith claim against State Farm. State Farm meanwhile appealed the judgment and, after it was affirmed, paid it in full.

In the ensuing bad faith litigation, the trial court allowed Campbell to introduce evidence that State Farm had a policy of encouraging claims handlers to use all manner of allegedly improper means to reduce claims payments. The evidence included some old claim manuals and other company documents, expert testimony placing the plaintiffs' spin on those documents, and the testimony of several former employees from around the country about particular practices,

most of which involved the handling of first–party claims for property damage to vehicles. There was almost no evidence of improper failure to settle third-party claims against insureds and, indeed, State Farm put on evidence showing that Campbell's was the only Utah case in 15 years in which an insured suffered an excess verdict and the company did not immediately pay the judgment or settle the case.

The jury found State Farm liable for bad faith, fraud, and intentional infliction of emotional distress. It awarded $911.25 in economic damages (the amount the Campbells paid their personal lawyers after the verdict to negotiate the assignment agreement with the judgment holders), $2.6 million in damages for mental anguish, and $145 million in punitive damages. The trial court remitted the compensatory damages to $1 million and the punitive damages to $25 million. State Farm appealed, and the Campbells cross-appealed on the issue of the proper amount of punitive damages. Relying on the evidence of the alleged policy of improperly reducing claims payments, evidence that State Farm had suffered a $100 million punitive verdict in a case in Texas that allegedly had not been reported to headquarters, and the very substantial size of State Farm's surplus, the Utah Supreme Court reinstated the full $145 million punitive award. The U.S. Supreme Court then granted certiorari to determine whether the reinstated award was unconstitutionally excessive.

The Decision

Finding the case "neither close nor difficult" (slip op. at 8), the Supreme Court ruled, by a 6-3 vote, that the $145 million punitive award was unconstitutionally excessive; moreover, it strongly suggested that anything beyond a 1:1 ratio to compensatory damages C *i.e.,* $1 million C would be unwarranted. The decision is rich with guidance for the proper administration of punitive damages in future cases, resolving a number of issues that had been dividing the lower courts in the wake of the Court's seminal punitive damages decision in *BMW of North America, Inc.* v. *Gore,* 517 U.S. 559 (1996).

Standard of Review

In *Cooper Industries, Inc.* v. *Leatherman Tool Group, Inc.*, 532 U.S. 424 (2001), the Supreme Court held that the determination whether a punitive award is unconstitutionally excessive is essentially a legal one and that federal courts of appeals must therefore review district courts' rulings on excessiveness challenges *de novo*. It was unclear from that decision, however, whether the *de novo* standard applies in state courts as well C *i.e.,* whether it was being imposed as a matter of the Court's supervisory power or as a matter of procedural due process. In *State Farm*, the Court appears to have clarified that *de novo* review is a constitutional mandate and therefore applies equally in state court, explaining that "[e]xacting appellate review ensures that an award of punitive damages is based upon an application of law, rather than a decisionmaker's caprice." Slip op. at 8.

Other Procedural Safeguards

In the course of explaining the importance of *de novo* appellate review, the Court made several observations that shed light on its mind set about punitive damages and should provide impetus for adoption of additional procedural safeguards in the future. For example, the Court explained:

> Although [punitive damages] awards serve the same purposes as criminal penalties, defendants subjected to punitive damages in civil cases have not been accorded the protections applicable in a criminal proceeding. This increases our concerns over the imprecise manner in which punitive damages systems are administered.

Slip op. at 6-7. It further observed that "[v]ague [jury] instructions * * * do little to aid the decisionmaker in its task of assigning appropriate weight to evidence that is relevant and evidence that is tangential or only inflammatory." *Id*. at 7.

These statements appear to invite lower courts to embrace additional safeguards that will make the administration of punitive damages less capricious. That might include bifurcating trials, excluding or limiting the use of evidence of the defendant's financial condition (a point discussed more fully below), controlling more tightly the admission of "tangential or

inflammatory" evidence, providing more detailed jury instructions, policing closing arguments more closely to discourage inflammatory rhetoric, and restricting plaintiffs' attorneys from asking juries to set punitive damages at amounts that, if actually awarded, would be excessive.

Further Guidance on the *BMW* Guideposts

In *BMW,* the Court identified three guideposts for determining whether a punitive award is unconstitutionally excessive: (i) the degree of reprehensibility of the conduct; (ii) the ratio of the punitive damages to the actual or potential harm to the plaintiff; and (iii) the disparity between the punitive damages and the legislatively established penalties for comparable conduct. Applying those guideposts, it found the $2 million punitive award in that case to be grossly excessive. The Court reiterated the *BMW* guideposts in *Cooper Industries* and conducted a preliminary analysis of the award under the guideposts to demonstrate why the Ninth Circuit's use of the wrong standard of review was not harmless error. Notwithstanding the guidance provided on the proper application of the *BMW* guideposts, many open questions remained. In *State Farm,* the Court appears to have resolved many of them in a way that should substantially rein in multi-million dollar punitive judgments.

The Reprehensibility Guidepost

The Court began its discussion of the reprehensibility guidepost by stating:

> We have instructed courts to determine the reprehensibility of a defendant['s conduct] by considering whether: the harm caused was physical as opposed to economic; the tortious conduct evinced an indifference to or reckless disregard of the health or safety of others; the target of the conduct had financial vulnerability; the conduct involved repeated actions or was an isolated incident; and the harm was the result of intentional malice, trickery, or deceit, or mere accident. ***The existence of any one of these factors weighing in favor of a plaintiff may not be sufficient to sustain a punitive damages award; and the absence of all of them renders any award suspect.***

Slip op. at 8 (emphasis added).

This pronouncement is important not just because it clearly sets forth relevant considerations, but also because it reminds lower courts that the existence of one or two of the factors favoring the plaintiff is not alone sufficient to justify an outsized punitive award.[1/] After

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[1/] The Court's identification of physical injury as a potential reprehensibility-enhancing factor is bound to lead plaintiffs to argue that the entire *BMW/State Farm* analysis has no application where the plaintiff has suffered physical injury. While the merits of such an argument are questionable, it remains to be seen to what extent this factor may impact the excessiveness

all, in *State Farm* itself the defendant had been held liable for fraud and the trial court had found that the plaintiffs were "economically vulnerable." (Dissenting opinion of Justice Ginsburg at 5.) More generally, the Supreme Court fully accepted that "State Farm's handling of the claims against the Campbells merits no praise," observing that the company's employees had altered documents, disregarded "the near-certain probability that, by taking the case to trial, a judgment in excess of the policy limits would be awarded," and falsely assured the Campbells that their assets would be safe from any verdict, only to tell them after the verdict that they would need to sell their home in order to cover the uninsured portion of the judgment. Slip op. at 8-9. Nevertheless, the Court concluded, "a more modest punishment for this reprehensible conduct could have satisfied the State's legitimate objectives, and the Utah courts should have gone no further." *Id*. at 9.

Of course, it is hardly earthshattering to say that even reprehensible conduct cannot generally justify a $145 million punitive award, but the Court did not stop there. After rejecting the various bases offered by the Utah courts for finding State Farm's conduct to warrant a high punishment and then discussing the other two *BMW* guideposts, the Court concluded that the conduct "likely would justify a punitive damages award at or near the amount of compensatory damages" C *i.e.,* $1 million. Slip op. at 18. Put another way, reprehensible though it may be, insurance bad faith and similar economically motivated torts generally do not warrant a punishment that significantly exceeds the amount of compensatory damages, at least when the latter are not insubstantial.

Extraterritorial Punishment

The Campbells, of course, had never contended that a punishment of $145 million was appropriate solely for the act of bad faith committed against them. Instead, they sought to demonstrate at trial that State Farm had a 20-year practice of using improper means to reduce claims payments. Their evidence included testimony by former employees about the purported mishandling of claims in various states as well as the use of out-of-state lawsuits to "impeach" State Farm witnesses. As the Supreme Court summarized it, "[f]rom their opening statements onward the Campbells framed this case as a chance to rebuke State Farm for its nationwide activities." Slip op. at 10. This feature of the case afforded the Court the opportunity to return to the issue of "extraterritorial punishment" that it had begun exploring in *BMW*.

The Court held in *BMW* that, while evidence of conduct affecting individuals in other states may be considered by a jury in gauging the degree of reprehensibility of the conduct directed toward the plaintiff, principles of sovereignty and comity preclude a jury from seeking to punish conduct directed at non-plaintiffs that was lawful where it occurred. Because there was no basis for concluding that the out-of-state transactions in *BMW* were unlawful in states other than Alabama, the Court left open the question whether a jury can impose punishment for out-of-state conduct directed at non-plaintiffs that is unlawful where it occurred.

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analysis in the lower courts. Ultimately, this is an issue that may well require the Supreme Court's further attention.

In *State Farm*, the Court not only answered this question, but also provided substantial additional guidance regarding the role of extraterritorial conduct. It began by reiterating that "[a] State cannot punish a defendant for conduct that may have been lawful where it occurred." Slip op. at 10. It then went on to answer the question left open in *BMW*, stating: "Nor, as a general rule, does a State have a legitimate concern in imposing punitive damages to punish a defendant for ***unlawful*** acts committed outside of the State's jurisdiction." *Id*. at 11 (emphasis added). The reason should be self-evident: "A basic principle of federalism is that each State may make its own reasoned judgment about what conduct is permitted or proscribed within its borders, and each State alone can determine what measures of punishment, if any, to impose on a defendant who acts within its jurisdiction." *Id*. at 12.

Of course, courts of one state long have adjudicated claims involving events that occurred elsewhere (subject to applicable principles of personal jurisdiction): that is why choice-of-law doctrine exists. Nothing in *State Farm* undermines that feature of the American judicial system, but the Court did helpfully clarify that "[a]ny proper adjudication of conduct that occurred outside [the forum state] to other persons would require their inclusion, and, to those parties, the [forum], in the usual case, would need to apply the laws of their relevant jurisdiction." Slip op. at 11. In other words, a court in one state may not punish a defendant for conduct directed at a person in another state unless that person is joined as a plaintiff (and hence is bound by any judgment) and the jury is instructed on the law of the other state. This pronouncement should put an end to efforts to justify punitive awards that are dozens or hundreds of times the plaintiff's compensatory damages as punishment for torts allegedly committed against non-plaintiffs in other states.

Indeed, not only does *State Farm* close the door to punishing for conduct (whether lawful or unlawful) on the basis of harms to out-of-state non-parties, it also makes clear the limits to the Court's statement in *BMW* that conduct directed at non-parties from other states may be used to gauge the degree of reprehensibility of the defendant's conduct toward the plaintiff. While recognizing that "[l]awful out-of-state conduct may be probative when it demonstrates the deliberateness and culpability of the defendant's action in the State where it is tortious" (slip op. at 11), the Court emphasized that, to serve that purpose, the conduct "must have a nexus to the specific harm suffered by the plaintiff" (*ibid*.). It admonished, moreover, that the jury must be instructed "that it may not use evidence of out-of-state conduct to punish a defendant for action that was lawful in the jurisdiction where it occurred." Slip op. at 11-12.

In sum, it appears clear after *State Farm* that (1) juries may not directly punish for out-of-state conduct directed at non-plaintiffs, whether or not the conduct is illegal where it occurred; and (2) out-of-state conduct may be considered in gauging the degree of reprehensibility of the conduct directed at the plaintiff only if the conduct is illegal in the relevant non-forum state ***and*** has a nexus to the punishable conduct that harmed the plaintiff.

Conduct Affecting Non-Parties Generally

The Court did not limit its analysis of the role of "other acts" to out-of-state conduct. Instead, it dramatically limited the extent to which plaintiffs can rely on conduct directed at non-

parties regardless of where the conduct took place. Returning to the "nexus" principle, the Court stated in categorical terms:

> A defendant's dissimilar acts, independent from the acts upon which liability was premised, may not serve as the basis for punitive damages. ***A defendant should be punished for the conduct that harmed the plaintiff, not for being an unsavory individual or business.***

Slip op. at 12 (emphasis added). It later added that, for a defendant to be treated as a recidivist warranting heightened punishment, "courts must ensure the conduct in question replicates the prior transgressions." *Id*. at 13.

It will remain for lower courts to determine on a case-by-case basis how close a nexus is required before evidence of other acts can "have relevance in the calculation of punitive damages" (slip op. at 13). It is significant, however, that the Supreme Court forcefully rejected the contention that State Farm's supposed plan to underpay claims supplied the required nexus between the evidence of first-party claims handling practices and the handling of the third-party claim against Curtis Campbell, stating that "[t]he reprehensibility guidepost does not permit courts to expand the scope of the case so that a defendant may be punished for any malfeasance, which in this case extended for a 20-year period." Slip op. at 14.

Perhaps even more important from a practical standpoint, the Court took pains to make clear that, even in cases where the same or closely similar conduct affected many individuals, thereby satisfying the "nexus" requirement, such evidence would not justify punishing the defendant for the impact of its conduct on non-parties. As the Court explained:

> Due process does not permit courts, in the calculation of punitive damages, to adjudicate the merits of other parties' hypothetical claims against a defendant under the guise of the reprehensibility analysis * * *. Punishment on these bases creates the possibility of multiple punitive damages awards for the same conduct; for in the usual case nonparties are not bound by the judgment some other plaintiff obtains.

Slip op. at 12.

In other words, while evidence of similar conduct may be admissible to show that the conduct directed at the plaintiff was not an isolated incident and hence was more reprehensible, the punitive damages must remain a modest multiple of the harm to the plaintiff lest the defendant be subjected to repeated and disproportionate punishments for the same harms. To make the point more concrete, while it may be permissible to impose punitive damages of twice or three times the compensatory damages when there is evidence that the defendant perpetrated similar acts against other individuals, this factor may not be used to justify an award that is 10 or 100 times the compensatory damages because nothing would prevent those other individuals

from bringing their own lawsuits, calling the same expert witnesses, introducing the same documents, and seeking the same disproportionate exaction. The Supreme Court's disapproval of using individual punitive damages cases as, in effect, one-way class actions in which punishment is inflicted for non-party harms should be of great value in curbing the recurrent strategy of plaintiffs' lawyers to invite each jury to impose global punishment for the full range of impacts of the defendant's conduct.

The Ratio Guidepost

The ratio guidepost has confounded lower courts since the Supreme Court first introduced it into the constitutional analysis, perhaps because the Court has "consistently rejected the notion that the constitutional line is marked by a simple mathematical formula." *BMW,* 517 U.S. at 582. In *State Farm*, though again declining "to impose a bright-line ratio which a punitive damages award cannot exceed" (slip op. at 14), the Court went far toward clearing up the confusion.

The Court began by announcing that "[o]ur jurisprudence and the principles it has now established demonstrate * * * that, in practice, few awards exceeding a single-digit ratio between punitive and compensatory damages, to a significant degree, will satisfy due process." Slip op. at 14. To bolster this point, it referenced the 4:1 ratio that it deemed to be "close to the line of constitutional impropriety" in *Pacific Mutual Life Insurance Co.* v. *Haslip,* 499 U.S. 1 (1991), as well as the "long legislative history, dating back over 700 years and going forward to today, providing for sanctions of double, treble, or quadruple damages to deter and punish." Slip op. at 14-15.

The Court reiterated its statement in *BMW* that "ratios greater than those we have previously upheld may comport with due process where 'particularly egregious act has resulted in only a small amount of economic damages.'" Slip op. at 15. But it added an important new directive: "The converse is also true * * *. ***When compensatory damages are substantial, then a lesser ratio, perhaps only equal to compensatory damages, can reach the outermost limit of the due process guarantee.***" *Ibid*. (emphasis added).

The Court then proceeded to evaluate the ratio before it. Significantly, it treated the ratio as being 145:1, notwithstanding the respondents=contention that the full amount of the excess verdict that State Farm had eventually paid, as well as the close to $1 million in attorneys' fees awarded to the Campbells, should be included in the denominator. Focusing on the nature of the compensatory damages that comprised the denominator, the Court observed:

> The compensatory award in this case was substantial: the Campbells were awarded $1 million for a year and a half of emotional distress. This was complete compensation. * * * The compensatory damages for the injury suffered here * * * likely were based on a component which was duplicated in the punitive award. Much of the distress was caused by the outrage and humiliation the Campbells suffered at the actions of their insurer;

> and it is a major role of punitive damages to condemn such conduct. Compensatory damages, however, already contain this punitive element.

Slip op. at 15-16. These observations no doubt contributed to its ultimate conclusion that "[a]n application of the *Gore* guideposts to the facts of this case, especially in light of the substantial compensatory damages awarded (a portion of which contained a punitive element), likely would justify a punitive damages award at or near the amount of compensatory damages" C *i.e.,* a ratio of 1:1 or less. *Id*. at 18.

The following guidelines may be deduced from the Court's pronouncements and its ultimate conclusion about the maximum permissible ratio in *Campbell*. First, only two circumstances are likely to warrant ratios in excess of single digits: (1) when the compensatory damages are nominal or very small and do not already embody a punitive component; and (2) when the conduct is truly beyond the pale C such as in the case of a malicious physical assault or deliberate homicide, a deliberate environmental crime (the dumping of toxic chemicals in a waterway under the cover of darkness), or perhaps a scam to defraud senior citizens out of their life savings. Second, when the conduct is not extraordinarily reprehensible, there is no evidence that it is part of a broader pattern of similar misconduct, the tort is essentially economic in character, and the compensatory damages are substantial, ratios much in excess of 1:1 may be constitutionally questionable. And while higher ratios may be tolerable in other cases, ratios above 4:1 are likely to attract a skeptical judicial eye.

Needless to say, these standards will dramatically alter the landscape of punitive damages litigation in a wide range of cases. Spurred by allegations of "unsavory" company-wide practices and evidence of multi-billion dollar surpluses, it has become increasingly common for juries to return C and courts to uphold C high ratios. After *State Farm*, punishments "at or near the amount of compensatory damages," or relatively modest multiples thereof, should become the norm.

The Comparative Fines Guidepost

Since *BMW*, the lower courts have been deeply divided over the question whether, in applying the third guidepost, the reviewing court should compare the punitive damages to the highest penalty theoretically possible for the general conduct at issue or instead should focus on the penalty that the defendant could realistically have expected to face for the specific conduct before the court. Courts hewing to the former position have focused both on criminal penalties that include imprisonment and on administrative penalties that are rarely if ever invoked. For example, in *State Farm* the Utah Supreme Court dispensed with the third guidepost by observing that, for its alleged company-wide practice of improperly denying or reducing the amount paid for claims, State Farm could lose its license to do business in Utah and its officers could be imprisoned.

The Supreme Court decisively resolved the disagreement among the lower courts by focusing on the fine that is realistically applicable to the conduct at issue. It began its analysis by

issuing a strong caution against relying on criminal penalties as a rationale for finding a high punitive award to be permissible:

> The existence of a criminal penalty does have bearing on the seriousness with which a State views the wrongful action. When used to determine the dollar amount of the award, however, the criminal penalty has less utility. Great care must be taken to avoid use of the civil process to assess criminal penalties that can be imposed only after the heightened protections of a criminal trial have been observed, including, of course, its higher standards of proof. ***Punitive damages are not a substitute for the criminal process, and the remote possibility of a criminal sanction does not automatically sustain a punitive damages award.***

Slip op. at 18 (emphasis added). The Court proceeded to reject the Utah Supreme Court's "speculat[ion] about the loss of State Farm's business licence, the disgorgement of profits, and possible imprisonment" on the ground that the assumption that State Farm could suffer such penalties was predicated on "the broad fraudulent scheme drawn from evidence of out-of-state and dissimilar conduct" as opposed to the specific conduct C an isolated instance of third-party bad faith C for which State Farm was being punished. *Ibid.* Instead, the Court said, "[t]he most relevant civil sanction under Utah state law for the wrong done to the Campbells appears to be a $10,000 fine for an act of fraud." *Ibid.*

The Court's analysis of the third guidepost in *State Farm* should have substantial significance in any punitive damages case in which there is a clearly applicable statutory fine or civil penalty.

The Role Of Corporate Financial Condition

When the Supreme Court identified guideposts for determining the reasonableness of punitive awards in *BMW*, it did not include corporate financial condition as a factor C even though the respondent had argued that the $2 million punishment in that case should be sustained on the ground that it was very modest in relation to BMW's substantial finances. To the contrary, the Court observed that "[t]he fact that BMW is a large corporation rather than an impecunious individual does not diminish its entitlement to fair notice of the demands that the several States impose on the conduct of its business." 517 U.S. at 585. In *Cooper Industries,* the Court again did not include corporate financial condition in its listing of the relevant guideposts C even though the lower courts had relied on it to uphold the $4.5 million punitive award at issue. Nevertheless, many courts C including the Utah Supreme Court in *State Farm* C continued to uphold large punitive awards on the ground that they were a modest percentage of the defendant's overall net worth, market capitalization, revenues, or income. In *State Farm*, the Supreme Court strongly indicated that financial condition is not in itself a valid basis for justifying a high punitive award C at least in the typical case of a corporate defendant committing an economically motivated tort.

The Court observed that a defendant's finances and various other factors invoked by the Utah Supreme Court to justify a high ratio of punitive to compensatory damages "bear no relation to the award's reasonableness or proportionality to the harm." Slip op. at 17. Rather, the Court explained, the wealth-based rationale and the other grounds invoked by the Utah Supreme Court are "arguments that seek to defend a departure from well-established constraints on punitive damages." *Ibid*. In short, it proclaimed, "[t]he wealth of a defendant cannot justify an otherwise unconstitutional punitive damages award." *Ibid.*

The most natural understanding of the Court's language, we believe, is that the excessiveness inquiry is ordinarily to be determined by the various other factors that the Court has identified. If, so judged, the award is deemed excessive, it cannot be saved by recourse to a corporate defendant's substantial finances. Nevertheless, because the Court's discussion of the subject is relatively terse, it is not unrealistic to expect that there will be continuing controversy regarding the nature of the limitation imposed by the *State Farm* decision on consideration of corporate finances.

Assuming, in accordance with the interpretation set forth above, that the lower courts accept that corporate finance can no longer be used as a routine inflator of punitive damages, the practical consequences should be substantial C perhaps more so than any other aspect of the decision. Evidence of the defendant's financial condition C accompanied by argument of counsel for a punitive award of "only" one percent (or some other seemingly modest percentage) of the defendant's net worth C appears to be the principal engine driving enormous punitive verdicts. Now, however, there are strong arguments for excluding such evidence and restricting such arguments. The likely upshot of thus altering the jury's numerical frame of reference should be awards more proportionate to compensatory damages. That is precisely the result the Supreme Court seemed to be striving for in holding that "courts must ensure that the measure of punishment is both reasonable and proportionate to the amount of harm to the plaintiff and to the general damages recovered." Slip op. at 15.

Conclusion

State Farm is a major development in the law of punitive damages. It should affect the kind of evidence that may be admitted at trial, the instructions that courts give, the amount of punitive damages that juries award, and the size of punitive judgments that reviewing courts allow to stand. Although there remain some circumstances in which a high punitive award can be justified, such instances should be sharply limited. In short, if faithfully implemented by the lower courts, the decision should accomplish the Court's evident purpose of restoring order to the administration of punitive damages.

Questions regarding the case and its implications should be directed to either Andy Frey (212-506-2635) or Evan Tager (202-263-3240).

MAYER, BROWN, ROWE & MAW WORLDWIDE

BRUSSELS
Square de Meeus 35
B1000 Brussels, Belgium
+322.502.5517

CHARLOTTE
Bank of America Corporate Center
100 North Tryon Street, Suite 2400
Charlotte, North Carolina 28202
704.444.3500

CHICAGO
190 South LaSalle Street
Chicago, Illinois 60603-3441
312.782.0600

COLOGNE
Kaiser-Wilhelm-Ring 27-29
50672 Cologne, Germany
+49.221.577.1100

FRANKFURT
Bockenheimer Landstrasse 98-100
D-60323 Frankfurt/Main, Germany
+49.69.79.41.00

HOUSTON
700 Louisiana Street
Suite 3600
Houston, Texas 77002-2730
713.221.1651

LONDON – PRINCIPAL OFFICE
11 Pilgrim Street
London EC4V 6RW
+44.0.20.7248.4282

LONDON – LLOYD'S OFFICE
Suite 892/874
Lloyd's
One Lime Street
London EC3M 7DQ
+44.0.20.7327.4144

LOS ANGELES
350 South Grand Avenue
25th Floor
Los Angeles, California 90071-1503
213.229.9500

MANCHESTER
Canada House
Chepstow Street
Manchester M1 5FW
+44.161.236.1612

NEW YORK
1675 Broadway
New York, New York 10019-5820
212.506.2500

PALO ALTO
555 College Street
Palo Alto, California 94306
650.331.2000

PARIS
13 Avenue Hoche
75008 Paris, France
+33.1.53.53.43.43

WASHINGTON
1909 K Street, N.W.
Washington, D.C. 20006-1101
202.263.3000

INDEPENDENT MEXICO CITY
CORRESPONDENT
Jáuregui, Navarrete,Nader y Rojas, S.C.
Torre Arcos
Paseo de los Tamarindos No. 400-B
Floors 7, 8 and 9
Col. Bosques de las Lomas
05120 Mexico, D.F.
+525.267.45.00

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