Conversations With...

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The Honorable Dick Thornburgh Andrew L. Frey

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The Issue: **Punitive Damages**

On April 7, 2003, in State Farm Mutual Life Ins. Co. v. Campbell, the U.S. Supreme Court issued its most definitive pronouncement on punitive damages to date. The Court's ruling will have a profound impact on a wide range of civil lawsuits, and comes at a time when judges and juries are issuing increasingly inflated punitive awards.

The Supreme Court spoke on a number of issues which the lower federal and state courts have been grappling with since the Court's last statement on exemplary damages seven years ago in BMW v. Gore. In addition to clearer statements on the compensatory-to-punitive ratio issue and definitive guidance on the key matter of extraterritorial punishment, the Court made its strongest statement yet about the role the defendant's wealth can play in determining a damage award amount.

As was the case after BMW, however, such clarity won't necessarily lead to a consistent application of the principles of State Farm, or an expanded body of punitive damages law which works to the benefit of defendants.

In this edition of Washington Legal Foundation's Conversations With, former Attorney General Dick Thornburgh leads a discussion on State Farm and how it will impact civil litigation with two of the nation's leading experts on punitive damages, appellate advocates Andrew L. Frey and Evan M. Tager.

Governor Thornburgh: Before we get into the specifics of the State Farm case, it might be helpful to briefly explain the philosophical underpinnings of punitive damages. How were they originally meant to be imposed, and how far have courts strayed from those original purposes?

Andrew Frey: Punitive damages originated in England in the 1760s and made their first appearance in the United States in the 1780s. They were viewed as a means of expressing societal disapproval for certain outrageous conduct such as unlawful searches by the King's officers, seduction, and breach of promise to marry - torts that typically produced only modest actual damages but were nevertheless viewed as particularly offensive. The additional liability was



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intended to provide just retribution and meaningful deterrence of such conduct. Until the second half of the 20th Century, punitive damages played a limited and sensible role in the American tort sytem, being applied relatively infre quently, in modest amounts, and principally against individuals for intentional torts.

During the last thirty or so years, however, there has been a substantial transformation in the role of punitive damages in our legal system, away from individual defendants and towards corporate defendants, and away from torts involving actual malice or intentionally inflicted harms and towards torts involving alleged recklessness or commercial frauds. In addition, the size of awards in the most visible cases has skyrocketed into the tens or hundreds of millions of dollars, and sometimes even billions of dollars. While such verdicts are not yet an everyday occurrence, they happen often enough to be of grave concern to the business community and to have a significant impact on the way cases are litigated and settled.

This stunning inflation of verdicts, especially in the last decade or so, has been due, in my opinion, in part to a reliance on corporate finances and in part to the fact that juries have become accustomed to hearing about enormous punitive verdicts in other cases being in effect desensitized to the true magnitude of the verdicts they are returning.

Governor Thornburgh: Some commentators, echoing the *State Farm* Court's language that "this case is neither close nor difficult," have argued that Justice Kennedy's opinion was merely an application of the Court's guideposts in *BMW of North America, Inc. v. Gore.*, and not a breakthrough in punitive damages law. What are your thoughts on that?

Evan Tager: I would add that the facts of *BMW* were so unsympathetic for the plaintiff that it was easy to argue that the decision was somewhat sui generis. Certainly there continued to be many decisions, especially in state courts, upholding substantial punitive damages and giving a rather grudging construction to *BMW*. *State Farm* makes it much harder to continue that pattern.

Governor Thornburgh: Let's discuss some of those refinements in more detail. What does the Court's analysis in *State Farm* add to determining the reprehensibility of defendant's conduct

Mr. Frey: While the Court reiterated the considerations it had identified in *BMW*, to me the most important aspect of its treatment of the subject is its insistence upon confining the conduct to be assessed for reprehensibility to that which quite specifically caused the plaintiff's harms, while rejecting consideration of other "bad acts" that were related to the injuring acts in the case only at a very broad level of generality (i.e., as part of a general scheme

¹517 U.S. 580 (2003).

to defraud customers or reap illicit profits by sacrificing safety, etc.).

Mr. Tager: It is important to note that the Court made a lot of other important pronouncements in the course of discussing the reprehensibility guidepost. First, it pointed out that several indicia of reprehensibility must coalece in the same case before a substantial award of punitive damages will be war-Second, it reminded courts that compensatory damages alone are often sufficient to accomplish the deterrent and retributive functions of punitive damages and that, as a consequence, substantial reprehensibility is necessary before any amount of punitive damages will be justifiable. Third, it clarified that states may not punish for the extraterritorial impacts of a defendant's conduct, even if the conduct is illegal in the state in which it occurred. Fourth, and perhaps most important of all, it held that juries may not punish defendants for harms caused to non-parties because doing so presents an unacceptable risk of multiple punishment.

Governor Thornburgh: In the context of reprehensibility, what will future litigants try to glean from the fact that *State Farm* involved neither physical injury nor economic harm, and from the Court's statements that State Farm's conduct merited "no praise"?

Mr. Frey: This may be the \$64,000 question (remember the days when we

thought amounts in the thousands were large?), at least for product liability cases. The plaintiffs' bar is arguing strenuously that because none of the Supreme Court cases in which the BMW/State Farm analysis developed involved physical injury or death, those decisions have no meaningful application to such cases. I consider this view to be wrongheaded. No doubt the degree of reprehensibility will appropriately affect the allowable ratio, but the Court plainly contemplated that this would occur within the ranges identified in the Court's ratio discussion.

I might add that sound economic analysis would suggest that products cases should generally produce the lowest ratios, even though they involve physical injury, because of the foundational principle of negligence/product-liability law that the optimal level of deterrence is achieved by making the negligent actor or the manufacturer of a defective product pay for the harms caused (i.e., that compensatory damages will ordinarily supply the desirable level of deterrence, and that less would under-deter and more would over-deter).

Mr. Tager: As for the second part of your question, the Court's statement that State Farm's conduct "merits no praise" and its later reference to "this reprehensible conduct" leaves room in many cases to argue that the reprehensibility of the conduct at issue was no more egregious and hence no more

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deserving of a substantial ratio of punitive to compensatory damages than in *State Farm*. Because the Supreme Court strongly suggested that a 1:1 ratio of punitive to compensatory damages (yielding a punishment of \$1 million) was the most that is permissible for State Farm's conduct, the ability to compare a defendant favorably to State Farm should be extraordinarily helpful in cabining punitive damages in a significant subset of cases.

Governor Thornburgh: In discussing reprehensibility, the opinion focused heavily on the trial court's consideration of State Farm's out-of-state conduct. What are your thoughts on what the Court said about this, especially on when such conduct can be used in the context of punitive damages?

Mr. Frey: There are two potential uses that might be made of out-of-state conduct: the jury might be invited to punish for such conduct and its alleged harmful consequences to others; or the conduct may be used evidentially to illuminate the claimed reprehensibility of the conduct. As for punishment, the Court made it clear that a jury in Utah was not at liberty to punish for harms suffered by alleged victims in other states (except where the out-ofstate plaintiff is a party to the case and the law of the other state is applied to the claim). But the "extraterritorial" aspect is not really all that significant here, for the Court also made clear that the jury had to be confined to punishing for the harms suffered by the plaintiff[s] in the case before it, and not other alleged victims, even instate ones.

The evidentiary question is trickier. Where evidence of other acts, even those occurring in or directly impacting only persons in other states, is probative of the defendant's state of mind, it would appear to be admissible under general evidentiary principles embodied in FEDERAL RULE OF LAW 404(b) (and will probably already have been admitted at the liability stage). On the other hand, the Court made it quite clear that dissimilar bad acts, adduced to show general bad character or because of their claimed relevance to a supposed illicit scheme described at a high level of generality (such as, in State Farm, holding down claims costs) are not to be considered. The question whether tendered evidence reflects conduct sufficiently similar to warrant its consideration in setting punishment is one that will have to be fleshed out by the lower courts.

Finally, there is the question of evidence of conduct that is lawful where it occurs, but unlawful in the forum state. I suspect that, in the end, such evidence will be admissible where the conduct harmed the plaintiff in the case at hand, but not as evidence of general reprehensibility.

Governor Thornburgh: How would you expect plaintiffs to react to this part of the Court's ruling?

Mr. Frey: They will continue to do their best to get in as much "bad acts" evidence as they can. The decision makes it more difficult for them to succeed in this endeavor.

Governor Thornburgh: Has there been any application of the Court's reasoning on out-of-state conduct in the lower courts thus far?

Mr. Tager: I haven't seen anything particularly illuminating yet, which may be a function of the fact that much of this ground had been covered in *BMW*, and courts like the Ninth Circuit in *White v. Ford Motor Co.*² had anticipated the rest.

Governor Thornburgh: Can defendants derive something for future use from the Court's reference to Campbell's plea during opening statements that the jury should punish State Farm for actions that state regulators failed to police?

Mr. Tager: The idea that juries should not be entrusted with the power of state regulators to punish for the effects of a defendant's conduct on non-parties was a central theme of two amicus briefs, the one that Andy and I did for the Chamber of Commerce and one filed by the American Council of Life Insurers. Although the Court didn't cite any amicus briefs by name, we believe that this theme resonated with the Court and underlies much of its opinion, including its specific statement that "[d]ue 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."

Governor Thornburgh: On the second *BMW v. Gore* guidepost - the compensatory-to-punitive ratio - did the Court give litigants any clearer guidance on what is "too much"?

Mr. Tager: The Court's discussion of ratio may well be the biggest contribution made in this decision. Although it rehashed a lot of statements it had made in earlier decisions, including the standard disclaimer that no single ratio is appropriate for every case, the Court added some new guidance. First, it held that ratios in excess of 9:1 are presumptively excessive and can be justified only when the damages are "small" and either (i) the conduct is "particularly egregious," (ii) the injury is hard to detect, or (iii) the compensatory damages undervalue the noneconomic injury. Then, it went on to say that "[w]hen compensatory damages are substantial, then a lesser ratio, perhaps only equal to compensatory damages, can reach the outermost limit of the due process guarantee." In other words, there will be a lot of cases in which a ratio of 1:1 is the constitutional maximum - a truly monumental development for business defendants.

Governor Thornburgh: In what circumstances could you see punitive damages above a single-digit ratio

²335 F.3d 833 (9th Cir. 2003

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being awarded? When might a ratio of 1:1 even be too much?

Mr. Frey: Again, the crucial prerequisite to double-digit ratios is the presence of only small or nominal actual damages. And even 1:1 would be too much in cases in which the defendant has had to pay substantial penalties, in which there is no possibility that the defendant's actions would escape liability, or in which substantial punitives would jeopardize the defendant's financial integrity or impair the ability of other injured parties to be compensated for their injuries, as punitive damages in asbestos cases appear to have done. And some courts have concluded that low ratios are all that are to be tolerated in cases involving what are essentially commercial business disputes between sophisticated entities; for example, even before State Farm, the Third Circuit in the *InterMed*,³ case reduced punitives from a 1:1 to a 1:48 ratio. One prime example, in my mind, of a case in which nothing more than nominal punitive damages can be justified is Exxon Valdez, where the company not only paid several billion dollars in compensatory damages but also fines of close to a billion dollars, as well as suffering an unprecedented public relations disaster; in such circumstances, it is impossible to justify additional significant punitive liability.

Governor Thornburgh: Are there risks in the Court being more specific on what ratio may be considered unconstitutional? Should more pre-

cise calculations be better left in the hands of legislatures, instead of judges?

Mr. Tager: Although I certainly endorse legislative caps on punitive damages (if properly constructed), courts can make a positive contribution as well. They have the benefit of making their determinations in the context of a concrete factual pattern and hence can provide greater refinement than the legislative process is able to bring to bear.

Mr. Frey: One idea that has long appealed to me is to have a commission establish guidelines akin to the sentencing guidelines widely used for criminal punishment-setting.

Governor Thornburgh: At the end of his analysis of the reasonableness of the award, Justice Kennedy made a rather pointed reference to the role a defendant's wealth should or should not play in determining punitive damages. What did the Court mean when it said "the wealth of a defendant cannot justify an otherwise unconstitutional punitive damage award"?

Mr. Tager: We think that this is a pretty clear statement that the defendant's financial condition is not a valid aggravating factor.

Governor Thornburgh: What impact will the Court's discussion have on plaintiffs' ability to make wealth an issue for juries?

³Inter Med. Supplies, Ltd. v. EBI Med. Sys., Inc., 181 F.3d 446 (3d Cir. 1999).

Mr. Tager: It seems to me that, by holding that the defendant's finances may not be used as an aggravating factor and further noting that such evidence bears no relation to the guideposts it has identified as bearing upon the reasonableness of a punitive award, the Court was signaling that, as a general rule, evidence of financial condition has no legitimate role to play in setting punitive damages. One exception is when the defendant wants to argue that a large punitive award will destroy it. In that circumstance, both parties should be allowed to introduce evidence of the defendant's finances. In addition, the opinion would appear to allow the use of financial evidence to assist the jury in choosing among penalties that are not unconstitutionally excessive. But given the highly prejudicial impact of such evidence, my view is that it should not be allowed for this purpose unless the trial court first determines the constitutional maximum and instructs the jury that the award cannot exceed that amount.

Mr. Frey: I might add that I consider the provision to the jury of a numerical framework within which it is to set punishment as crucially important in guiding the inquiry, which is one as to which the jury has little experience or truly useful instruction. Use of corporate wealth provides a large-number frame of reference that, I am convinced, seriously distorts the jury's inquiry. In one case I know of, for example, the jurors when interviewed after rendering a \$150 million punitive

verdict recounted that they did not view the defendant's conduct as especially grave and therefore selected a "modest" punishment equaling only 0.5% of the defendant's net worth.

In any event, there is little doubt that the use of wealth evidence in punishment-setting will be a fertile ground for future battles.

Governor Thornburgh: On applying the final *BMW* guidepost - the disparity between punitive damages and legislatively-established penalties for comparable conduct - did the Court break any new ground and if so, what impact might it have in the lower courts?

Mr. Tager: This is a much-overlooked and under-appreciated part of the opinion. Before the decision in State Farm, there was a raging debate between the plaintiffs' bar and the defense bar over whether the proper focus of the third guidepost is on hypothetical maximum penalties or instead on the penalties that realistically could be imposed for the conduct in question. The Supreme Court came down solidly on the side of the latter view, rejecting the Utah Supreme Court's reliance on the preposterous notion that State Farm's officers could have been imprisoned and the company's license could have been suspended, and instead holding that the proper comparison was with the \$10,000 fine for violation of Utah's unfair claims practices statute. That holding should be enormously helpful in any case in

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which there is a statutory fine or administratively established civil penalty for the specific conduct at issue.

Governor Thornburgh: What issues in the Court's analytical framework do you feel *State Farm* left unresolved or greatly open to interpretation?

Mr. Tager: Part II of the opinion seems to be an admonition that lower courts need to start strengthening the procedural protections afforded to defendants in punitive damages cases. My expectation is that we are going to see an increasing number of cases addressing required jury instructions, evidentiary limitations, bifurcation, and limitations on inflammatory rhetoric. In addition, as we have already discussed above, there is at least some room to argue over such issues as: the significance of physical injury or death to the application of the BMW/State Farm analysis; what ratios are allowable (the field of battle having shifted very favorably towards the defense side, but not conclusively within the single-digit realm); characterization of other acts as similar or dissimilar; and the role (if any) of wealth evidence in setting punishment.

Governor Thornburgh: In light of State Farm, the Court vacated and remanded at least three punitive damage cases involving physical injury, Ford Motor Co. v. Estate of Smith, Ford Motor Co. v. Romo, and Philip Morris USA, Inc. v. Williams. What meaning can be derived from this, and how do you think these cases will be resolved on remand?

Mr. Frey: While these are not decisions on the merits, they strongly suggest that the Court views the decisional framework that it has developed as being applicable to personal injury and death cases. It is reasonable to predict that the punitive awards in each of these cases will be slashed dramatically.

Governor Thornburgh: Are there any other cases currently pending in the lower state and federal courts that are worth watching as indications of how State Farm will be applied?

Mr. Tager: The two cases remanded to the Oregon Court of Appeals should be significant. One, Edwards v. Key Pharmaceuticals,7 already has been decided. Although there is some language in the opinion that is not helpful for defendants, on balance the decision is favorable, reducing a \$22.5 million punitive award to \$3.5 million, acknowledging that single-digit ratios are the maximum permissible when damager are not small, and further stating that especially egregious conduct is necessary to justify ratios in excess of 4:1. The other case, Waddill v. Anchor Hocking,8 will test the court's willingness to place product liability cases on a spectrum of reprehensibility. If the court takes its own opinion in Edwards seriously, it is hard to see how a ratio of more than 4:1 can be permitted in Waddill. Another potentially important post-State Farm case is Eden Electrical v. Amana Co.9 That case involves a business-on-business tort, and the compensatory damages are high, so it seems to me like a perfect candidate for

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- ⁴ Ford Motor Co. v. Estate of Smith, 2003 U.S. LEXIS 3679 (May 19, 2003), vacating Sand Hill Energy, Inc. v. Ford Motor Co., 83 S.W.3d 483 (Ky. 2002).
- ⁵ Ford Motor Co. v. Romo, 2003
 U.S. LEXIS 3680 (May 19, 2003), vacating 99 Cal. App.
 4th 1115 (2002).
- ⁶ 2003 U.S. LEXIS 5437 (Oct. 6, 2003), vacating Williams v. Philip Morris USA, Inc., 183 Ore. App. 192 (2002).
- 7 123 S. Ct. 1781 (2003),
 vacating Bocci v. Key
 Pharmaceuticals, 178 Ore. App. 42 (2001).
- 8 123 S. Ct. 1781 (2003), vacating Anchor Hocking v. Waddill, 175 Ore. App. 294 (2001).
- ⁹ Eden Electrical, Ltd., et al. v. Amana Company, L.P., 258 F. Supp. 2d 958 (N.D. Iowa 2003).

the 1:1 cut-off mentioned in *State Farm*. It's also worth mentioning that various divisions of the California Court of Appeal already have rendered decisions in excessiveness cases. In a series of decisions, one seems to have drawn a pretty firm line at 4:1. And in a tobacco case, another California appellate court reduced a \$25 million punitive award to \$9 million, a 6:1 ratio. Even these levels seem high, but things are still in the process of shaking out.

Governor Thornburgh: Strategically speaking, what can defendants do to best respond to the *State Farm* Court's guidance on punitive damages? How will plaintiffs' lawyers respond? Will the amounts and frequency of punitive damages being requested in litigation change at all?

Mr. Frey: This is a very broad question, so I will try just to hit a few of the high spots. For plaintiffs, I don't see a dramatic change in trial tactics; rather, they should be seeking to continue, as much as they will be permitted, to do what they have been doing. For defendants, there are more opportunities for in limine motions to keep out dissimilar acts or wealth evidence and to restrict plaintiffs' arguments that invite punishments for harms to others, place exaggerated reliance on financial evidence (if it is allowed in), or ask the jury to return an award that would be struck down as excessive if it did so. And State Farm offers substantial bases for requesting more detailed jury instructions to circumscribe the punishment inquiry. The reader might wish to refer in this connection to an article I wrote that appears in the Fall 2003 issue of *Litgation* addressing the need for improved model or pattern instructions on punitive damages.¹⁰

Governor Thornburgh: Do you think federal and state courts, especially state supreme courts, may develop additional procedural safeguards to protect defendants' rights after the *State Farm* Court spoke so strongly about the need for protections? Do you anticipate any legislative activity to cap or impose more limits on punitive damages?

Mr. Tager: I definitely think that the courts are going to be more receptive to arguments for additional procedural safeguards, but they can't be expected to devise new procedures on their own. It will be up to the defense bar to tell the courts what they want and why it is warranted. As for legislative reform, my guess is that the plaintiffs' bar will invoke *State Farm* as a rationale for why caps are unnecessary. The defense bar can counter, however, by emphasizing the Supreme Court's call for procedural safeguards, which can usefully be addressed legislatively.

Governor Thornburgh: At the outset, we began this discussion by talking about the original purpose of punitive damages, and how courts and juries have taken their application far away from those original purposes. How far will *State Farm* and perhaps more similar rulings in the lower courts go

¹⁰ 29 LITGATION No. 4, at 24 (Summer 2003).

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towards restoring these damages to their original, limited purpose?

Mr. Tager: A pathbreaking article by GWU law professor Tom Colby that came out in the Minnesota Law Review shortly before *State Farm* was decided persuasively establishes that the use of punitive damages to punish defendants for harms to non-parties is a dramatic departure from historical practice.¹¹ The Court's holding that juries may not punish for harms to non-parties should return punitive damages to their original purpose of punishing only for harm to a specific individual.

Mr. Frey: It will help a great deal, but the battle is far from over. The demand for punitive damages, especially against large corporate defendants, reflects a deeply ingrained populist streak that appeals to many jurors, judges, and lawmakers. The business community should not rest on its laurels in the vigorous pursuit of reforms, through legislation and litigation both, to protect against the persistent tendencies to excesses ingrained in much of contemporary punitive damages law and practice.

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give frank thoughts on a wide range of important contemporary subjects.

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Biographies

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Andrew L. Frey is a partner in the New York office of the law firm Mayer, Brown, Rowe & Maw LLP specializing in U.S. Supreme Court, federal court of appeals, and state supreme court practice and in punitive damages litigation. During his career in private law practice and formerly as Deputy Solicitor General and Assistant to the Solicitor General of the United States, Mr. Frey has argued over 60 cases before the U.S. Supreme Court.

Evan M. Tager is a partner in the Washington office of Mayer, Brown, Rowe & Maw LLP specializing in appellate and general litigation, with a special focus on appeals of punitive damage awards. He has written extensively on punitive damages litigation and other key civil litigation topics. He previously served as a law clerk to the Honorable Mary M. Schroeder of the U.S. Court of Appeals for the Ninth Circuit.

^{11.} Thomas B. Colby, Beyond the Multiple Punishment Problem: Punitive Damages as Punishment for Individual, Private Wrongs, 87 Minn. L. Rev. 583 (Feb. 2003).