

Applying Constitutional Limits on Punitive Damages to Franchise Disputes

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The U.S. Supreme Court's recent decision in *State Farm Mutual Insurance Co. v. Campbell*¹ marks anew the constitutional limits on punitive damages. The six-Justice majority (Scalia, Thomas, and Ginsburg each dissented separately) reversed and remanded the Utah Supreme Court's decision reinstating a \$145 million punitive damage verdict, which the trial court had reduced to \$25 million. *State Farm* was not a franchise case; it involved an insurer's failure to settle a personal injury suit. But in several crucial respects, Justice Kennedy's opinion clarifies punitive damage issues likely to arise in franchise disputes, and may make it significantly harder for plaintiff franchisees to win and hold large punitive damage awards.

The State Farm Facts and Utah Court Proceedings

State Farm's insured Curtis Campbell caused a horrible traffic accident in Utah, killing the driver of a second car and permanently disabling the driver of a third vehicle. Notwithstanding all the evidence that Campbell's "unsafe pass had indeed caused the crash," State Farm decided to contest liability and rejected offers to settle for the \$50,000 policy limit.² The company also advised Campbell that it would protect his interests and that he had no need to retain separate counsel. The jury found Campbell 100 percent at fault and returned a verdict for \$185,849. At first State Farm refused to pay the portion of the verdict over the policy limit, but after the Utah Supreme Court affirmed the judgment, the insurer satisfied the full amount.

Campbell and his wife still sued, charging State Farm with bad faith, fraud, and intentional infliction of emotional distress because of its initial refusal to pay more than the policy limit. The trial court granted State Farm summary judgment, but the intermediate appellate court reversed. The proceedings on remand were bifurcated. "In the first phase, the jury determined that State Farm's decision not to settle was unreasonable because there was a substantial likelihood of an excess verdict."³ In the second phase, the jury decided the insurer's "liability for fraud and intentional infliction of emotional distress, as well as compensatory and punitive damages."⁴ After State Farm unsuccessfully moved to preclude evidence of out-of-state conduct, the trial turned into a

wide-ranging examination of the company's nationwide claims settlement practices—what the Utah Supreme Court later called "a national scheme to meet corporate fiscal goals by capping payouts on claims company wide."⁵

After hearing evidence about "State Farm's business practices for over 20 years in numerous other states," most of which "bore no relation to . . . the type of claim underlying . . . the Campbells' claim against the company," the jury awarded the Campbells \$2.6 million in compensatory damages and \$145 million in punitive damages.⁶ The trial court reduced the award to \$1 million in compensatories and \$25 million in punitives.

The Utah Supreme Court, purporting to apply *BMW v. Gore*⁷ (the U.S. Supreme Court's lead decision on the constitutionality of punitive damages), reinstated the \$145 million punitive damage verdict. Based largely on evidence of State Farm's nationwide practices, the court concluded that the company's behavior was reprehensible. In addition, because of the insurer's "massive wealth," and substantial evidence that State Farm's bad acts were likely to go unpunished in the overwhelming majority of cases, the Utah Supreme Court held that a punitive-to-compensatory-damage ratio of 145 to 1 "was not unwarranted."⁸ The court also reasoned that punishment so severe was in line with "the civil and criminal penalties State Farm could have faced."⁹

The U.S. Supreme Court Disagrees

The U.S. Supreme Court could hardly have disagreed more with the Utah Supreme Court's approach. To understand why, it is necessary to review briefly the *BMW v. Gore* "guideposts" for assessing the constitutionality of punitive damage awards.

The *Gore* Court vacated a \$2 million punitive damage award in a case with \$4,000 in actual damages, holding that the award was grossly excessive and therefore unconstitutional.¹⁰

Gore identified a three part constitutional analysis: (1) the degree of reprehensibility of the conduct at issue, in light of all of the facts in the record; (2) the ratio of the punitive damages to the actual and potential harm inflicted on the plaintiff; and (3) the criminal or civil penalties that the state could impose for comparable misconduct.¹¹

Reprehensibility of Conduct

According to *Gore*, "[p]erhaps the most important indicium of the reasonableness of a punitive damages award is the degree of reprehensibility of the defendant's conduct. . . . This principle reflects the accepted view that some wrongs

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are more blameworthy than others.”¹² *Gore* discussed three “aggravating factors associated with particularly reprehensible conduct”: (1) whether a defendant’s conduct was violent or presented a threat of violence, (2) whether a defendant acted with deceit or malice as opposed to acting with mere negligence, and (3) whether a defendant has engaged in repeated instances of misconduct.¹³ The U.S. Supreme Court thus established a “hierarchy of reprehensibility,” ranging from violence or threats of bodily harm at the top, down to reckless disregard for the health and safety of others, then to affirmative acts of trickery and deceit, with acts of omission and mere negligence at the bottom.¹⁴

Punitive damages were awarded in *Gore* because the manufacturer failed to disclose to the plaintiff that it repainted his car, damaged in transit, before he bought it as new. Justice Stevens noted that the harm caused by BMW’s conduct was “purely economic in nature,” and “evinced no indifference to or reckless disregard for the health and safety of others.”¹⁵ The Court also focused on the absence of a repeated course of prohibited conduct that BMW knew or suspected was illegal. “Certainly, evidence that a defendant has repeatedly engaged in prohibited conduct while knowing or suspecting that it was unlawful would provide relevant support for an argument that strong medicine is required to cure the defendant’s disrespect for the law.”¹⁶ However, the Court found that in the absence of a court ruling to the contrary, BMW could reasonably have believed that its conduct was entirely legal.

The Court also emphasized that the manufacturer had not persisted in the improper course of conduct “on even one occasion, let alone repeated occasions.”¹⁷ As Justice Stevens concluded: “That conduct is sufficiently reprehensible to give rise to tort liability, and even a modest award of exemplary damages does not establish the high degree of culpability that warrants a substantial punitive damages award.”¹⁸

Proportionality

Gore also declared that “[t]he second and perhaps most commonly cited indicium of an unreasonable or excessive punitive damages award is its ratio to the actual harm inflicted on the plaintiff.”¹⁹ Although the U.S. Supreme Court has never adopted (at least until *State Farm*) a “simple mathematical formula” for determining the constitutionally acceptable ratio of punitive to compensatory damages,²⁰ in *Gore* it repeatedly stressed that the amount of punitive damages must reasonably relate to the harm that the defendant caused.

Other Established Penalties for the Misconduct

The third *Gore* guidepost is a comparison of “the punitive damages award and the civil or criminal penalties that could be imposed for comparable misconduct.”²¹ The highest statutory penalty authorized by any state in the country for misconduct comparable to BMW’s was only \$10,000, as compared to the \$2 million punitive damages award. This heavily influenced the Court’s decision to reverse in *Gore*, because these statutory penalties did not provide BMW “with fair notice that the first violation . . . might subject an

offender to a multimillion dollar penalty.”²²

It is fair to say that courts have treated the relationship among the *Gore* guideposts as extremely fluid. Because there is no fixed scale for grading any of the three factors, if, for example, the subject conduct is extraordinarily reprehensible, that has been thought to justify a greater disproportion between the punitive and compensatory damages even if the civil penalties for comparable misconduct are relatively small.²³

Implications of *State Farm* for Franchise Disputes

As mentioned above, the Utah Supreme Court said that it was applying the *Gore* guideposts, but to the U.S. Supreme Court majority, the decision to reverse *State Farm* was “neither close nor difficult.”²⁴ *State Farm* appears to go well beyond *Gore*, moreover, sounding the end for certain practices that have long been commonplace in punitive damage litigation.

Anyone who has ever defended a successful corporation against a punitive damage claim knows the drill: the plaintiff’s lawyer spends a little bit of time talking about what happened to the plaintiff and a whole lot of time describing the company as a really rich, really bad actor that got rich by mistreating countless victims in addition to the plaintiff. That approach can be especially well suited to franchise cases, because every successful franchisor has many franchisees and systemwide policies and practices affecting all of them. But this mode of argument may eventually become a thing of the past, thanks to *State Farm*.

Writing for the majority, Justice Kennedy chastised the Utah Supreme Court because “*State Farm* was being condemned for its nationwide policies rather than for the conduct directed toward the Campbells,” and the “case . . . was used as a platform to expose, and punish, the perceived deficiencies of *State Farm*’s operations throughout the country.”²⁵ He observed that a state generally has no legitimate interest in punishing a party for harm caused outside the jurisdiction; “proper adjudication of that conduct” would require adding as parties those allegedly injured by the conduct, and applying the law of the other jurisdictions where the conduct or injury occurred.²⁶

But Justice Kennedy went further still, criticizing the Utah courts because they “awarded punitive damages to punish and deter conduct that has no relation to . . . [the plaintiff insured’s] harm.”²⁷

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.* 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, but we have no doubt that the Utah Supreme Court did that here.²⁸

Of course, the bounds of relevant evidence would be dramatically broader in a class action seeking punitive damages.

Even in cases with single plaintiffs, *State Farm* may leave the door slightly ajar for evidence of the defendant's conduct toward others, if that conduct is closely similar to what happened to the plaintiff and occurred, or caused harm, in the same jurisdiction.²⁹

Punitive Damages and Wealth of the Defendant

State Farm conclusively establishes, however, that the Constitution does not allow a larger punitive damage award simply because the defendant is rich. *Gore* pointed at this conclusion, among other reasons because it never mentioned the defendant's assets as a proper factor in the constitutional analysis, but *State Farm* squarely holds that "[t]he wealth of a defendant cannot justify an otherwise unconstitutional punitive damages award."³⁰ Thus, if the punitive damages would flunk the *Gore* test when awarded against a less well-healed defendant, that the defendant is a large corporation or rich individual cannot, as a matter of constitutional law, pull the award to a passing grade.

This aspect of *State Farm* has the potential to transform fundamentally the trial of punitive damage claims. Because punishment and deterrence are the purposes of punitive damages, plaintiffs' lawyers suing wealthy defendants have traditionally stressed that punitive damage awards must take enough of the defendants' assets for them to "feel it" and "get the message that they must change." Most trial judges have accepted these refrains as perfectly appropriate. Undoubtedly, therefore, it will take considerable time, and many further reminders from appellate courts, before such arguments are history. But any franchisor defending a punitive damage claim must understand this part of the *State Farm* holding, and use it in a continuing effort to keep out evidence, shape the jury charge, and police the conduct of plaintiff's counsel—especially in closing argument. If the trial judge does not appreciate that we have entered a new era in punitive damage litigation, carefully preserving the record on this issue will also be critical to success on appeal.

Other Factors Related to Franchises

Three other features of *State Farm* also deserve mention here, since they are likely to play an important part in any franchise case with a punitive damage claim. First, as in *Gore* the Court "decline[d] again to impose a bright-line ratio which a punitive damage award cannot exceed."³¹ But "in practice," Justice Kennedy observed, "few awards exceeding a single digit ratio between punitive and compensatory damages, to a significant degree, will satisfy due process."³² The exception would be "where 'a particularly egregious act has resulted in only a small amount of economic damages.'"³³ However, because franchisee claims against franchisors almost always involve only economic loss, as opposed to personal injury, and even fraudulent conduct causing economic damage ranks relatively low on the *Gore* scale of reprehensibility, it appears highly improbable that a franchise case would ever present such exceptional circumstances. Under *State Farm*, moreover, if "compensatory damages are substantial, then a lesser ratio, perhaps only equal to com-

pensatory damages, can reach the outermost limit of the constitutional guarantee."³⁴ That scenario seems far more likely in a franchise dispute.

Second, *State Farm* illustrates that even indisputably egregious, bad faith business activity is unlikely to offend a majority of this Supreme Court sufficiently for it to embrace a huge punitive damage award, at least when the conduct did not cause personal injury. *State Farm*'s employees had "altered the company's records to make Campbell appear less culpable."³⁵ The insurer also ignored "the near-certain probability" of a verdict exceeding the policy limits, and then "amplified the harm by at first assuring the Campbells their assets would be safe from any verdict and by later telling them, postjudgment, to put a for-sale sign on their house."³⁶ The Court conceded that *State Farm*'s conduct "merits no praise," and was careful to say that awarding some amount of punitive damages was not error.³⁷ But in the *State Farm* majority's view, "a more moderate punishment for this reprehensible conduct could have satisfied the State's legitimate objectives, and the Utah courts should have gone no further."³⁸ It is nonetheless worth remembering, however, that "reprehensibility" is a highly subjective and elastic concept, allowing different courts to reach radically different conclusions based on essentially similar facts. That characteristic of the first *Gore* guidepost underscores the importance of *State Farm*'s presumption on proportionality—that any double-digit ratio of punitive to compensatory damages is constitutionally suspect.

Punitive Damages and Civil Penalties

Finally, *State Farm* also adds new heft to the third *Gore* guidepost, the relationship "between the punitive damages award and the 'civil penalties authorized or imposed in comparable cases.'"³⁹ In *State Farm*, the Utah Supreme Court had looked beyond the \$10,000 statutory penalty that might have applied to a single act of civil fraud by an insurer, to engage in what the U.S. Supreme Court dismissed as speculation "about the loss of *State Farm*'s business license, the disgorgement of profits, and possible imprisonment, but here again its references were to the broad fraudulent scheme drawn from evidence of out-of-state and dissimilar conduct."⁴⁰

Although the third *Gore* guidepost has probably received less attention than have the reprehensibility and proportionality requirements, it can be an important tool in defending punitive damage claims and seeking to overturn punitive damage awards, especially in cases involving a regulated activity like franchising. Franchise statutes and regulations and unfair trade practice statutes often impose civil penalties for each violation, but the amounts are sometimes quite modest.⁴¹ *State Farm* establishes that the proper focus under this guidepost is the civil financial penalty, if any, for the conduct affecting the individual plaintiff. In many franchise cases, that penalty may not be large enough to help sustain a substantial punitive damage award.

In our next issue, I will address another punitive damage question that should be of particular concern to franchisors and franchisees, given the frequent arbitration of franchise

disputes—whether the *Gore/State Farm* constitutional limits apply to arbitral punitive damage awards.

Endnotes

1. 538 U.S. ___, slip op. (Apr. 7, 2003).
2. *Id.* at 2.
3. *Id.* at 3.
4. *Id.*
5. *Id.* at 4.
6. *Id.*
7. 517 U.S. 559 (1996).
8. *State Farm*, 538 U.S. ___, slip op. at 5.
9. *Id.*
10. *Gore*, 517 U.S. at 562.
11. *Id.* at 575–85.
12. *Id.* at 575.
13. *Lee v. Edwards*, 101 F.3d 805, 809 (2d Cir. 1996).
14. *Swinton v. Potomac Corp.*, 270 F.3d 794, 818 (9th Cir. 2001).
15. *Gore*, 517 U.S. at 575–76.
16. *Id.* at 576–77 (citation omitted).
17. *Id.* at 580.
18. *Id.* (emphasis added).
19. *Id.* (citations omitted).
20. *TXO Prod. Corp. v. Alliance Res. Corp.*, 509 U.S. 443, 462 n.28 (1993) (“We need not, and indeed we cannot, draw a mathematical bright line between the constitutionally acceptable and the constitutionally unacceptable that would fit every case.”) (quoting *Pacific Mut. Life Ins. Co. v. Haslip*, 499 U.S. 1, 18 (1991)).
21. *Gore*, 517 U.S. at 583 (“When penalties for comparable misconduct are much slighter than a punitive damages award, it may be said that the tortfeasor lacked ‘fair notice’ that the wrongful conduct could entail a substantial punitive award.”).
22. *Id.* at 584.
23. *See, e.g., id.* at 582 (“Indeed, low awards of compensatory dam-

ages may properly support a higher ratio than high compensatory awards, if, for example, a particularly egregious act has resulted in only a small amount of economic damages.”).

24. *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. ___, slip op. at 8.
25. *Id.* at 9.
26. *Id.* at 11.
27. *Id.* at 12.
28. *Id.* at 13.
29. The U.S. Supreme Court continues to recognize, even in *State Farm*, that “repeated conduct is more reprehensible than an individual instance of malfeasance.” *Id.*, quoting *BMW v. Gore*, 517 U.S. 559, 577 (1996). *See also* *TXO Prod. Corp. v. Alliance Res. Corp.*, 509 U.S. 443, 462 n.28 (noting that courts should look to “the existence and frequency of past similar conduct”).
30. *State Farm*, 538 U.S. ___, slip op. at 17.
31. *Id.* at 14.
32. *Id.*
33. *Id.* at 15, quoting *Gore*, 517 U.S. at 581.
34. *Id.*
35. *Id.* at 9.
36. *Id.*
37. *Id.*
38. *Id.*
39. *Id.* at 18, quoting *BMW v. Gore*, 517 U.S. 559, 575 (1996).
40. *Id.*
41. *See, e.g.,* CAL. CORP. CODE § 31405 (imposing a maximum penalty of \$2,500 for violating the California Franchise Investment Act); 815 ILL. COMP. STATS. 705/24 (maximum civil penalty of \$50,000 for violating the Illinois Franchise Disclosure Act of 1987); CONN. GEN. STAT. § 42–100o (maximum civil penalty of \$5,000 for “willful” violation of state unfair trade practices act). *See also* 15 U.S.C. § 45(m)(1)(a) (imposing a maximum penalty of \$10,000 for violation of the Federal Trade Commission Act, including the FTC’s Franchise Rule, 16 C.F.R. § 436.1).