

## **From TXO to Campbell: How Potential Damages Can Maximize Punitive-Damage Recoveries in Insurance Bad-Faith Cases**

### Introduction

If the defense bar were to be believed, the United States Supreme Court's recent decision in *State Farm Mutual Automobile Insurance Company v. Campbell*, \_\_\_ U.S. \_\_\_, 123 S.Ct. 1513 (2003) ("Campbell") has conclusively capped the punitive compensatory damages ratio in insurance-bad-faith cases at anywhere between 1-1 and 9-1. And the even more recent decision by California's fourth-appellate district in *Diamond Woodworks, Inc. v. Argonaut Insurance Company* (2003) 2003 WL 21361143 ("Diamond Woodworks") proposes that this ratio be capped at 4-1.

But the widely perceived 9-1 or 4-1 cap is neither the holding in *Campbell* nor as limiting as it may appear. As the *Diamond Woodworks* case completely omitted and as the *Campbell* Court reaffirmed, the Supreme Court's statement in *TXO Production Corp. v. Alliance Resources Corp.*, 509 U.S. 443 (1993) of the controlling law is that courts may place in the ratio's denominator either actual or potential damages. *Diamond Woodworks'* failure to consider any "potential damages" thus minimizes the reach of its holding. The inclusion of potential damages as part of the ratio can have a significant impact on that analysis. For example, if actual damages are only \$50,000, but the potential damages from the defendant's wrongful conduct are \$10,000,000, then a 9-1 ratio would yield a punitive award of not \$450,000 ( \$50,000 multiplied by 9), but rather \$90 million (\$10 million multiplied by 9). As a result, punitive compensatory ratios may still be large when based on sufficient evidence demonstrating the potential damages arising from the insurer's bad faith conduct.

### Holding in *Campbell*

The issue in *Campbell* was whether, under the facts of that particular case, a \$145 million punitive award was excessive and in violation of the due process clause in the 14th Amendment to the U.S. Constitution. The Court's opinion ultimately reduced the punitive-damages award to \$1 million, finding the \$145 million award to be an irrational, an arbitrary deprivation of *State Farm's* property, excessive, and in violation of the due process clause.

### *BMW v. Gore* Guideposts

#### Include Punitive-Harm Ratio

In its reasoning, the *Campbell* Court relied heavily on its holding seven years earlier in *BMW of North America, Inc. v. Gore*, 517 U.S. 559, 116 S.Ct. 1589 (1996) ("BMW"), the first time ever that the Court invalidated a state-court punitive damages award as unreasonably large. The Court in *BMW* set the following three guideposts for reviewing punitive-damages awards:

- (1) Reprehensibility of conduct – the most important factor;
- (2) Ratio of punitive award to the actual or potential harm caused; and
- (3) Difference between punitive award and civil penalties authorized in similar cases.

For the second guidepost, the ratio between punitive damages and the actual or potential damages caused, the *Campbell* Court explicitly and strongly stated that there did not exist, and it was not here setting, any

bright-line ratio, rigid benchmark, or mathematical formula to limit punitive awards. The Court emphasized that this ratio was ultimately dependent on the facts of each particular case. Nevertheless, California's fourth-appellate district in *Diamond Woodworks* assembled several quotes from the *Campbell* opinion – inconsistent with the above statement that there was no established limit – to determine that the ratio is conclusively capped at 4-1.

#### Campbell Quotes Favored by Defendant Insurers

While we await other California appellate districts to weigh in on applying *Campbell* to the propriety of a particular punitive award, the *Diamond Woodworks* opinion highlights from *Campbell* two quotes that defense counsel will likely seize on and emphasize in post-verdict papers:

1) “. . . [F]ew awards exceeding a single-digit ratio [i.e., from 1-1 to 9-1] between punitive and compensatory damages, to a significant degree, will satisfy due process.”

2) “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.”

Insurers will surely cite to these quotes to support their claim that where compensatory damages are small to moderate, then 9-1 is the highest punitive compensatory ratio, or, under *Diamond Woodworks*, 4-1; and, where compensatory damages are substantial, they should be matched but not exceeded by the amount of punitive damages, i.e., a 1-1 ratio.

But the first quote from *Campbell*, above, implies that some awards exceeding a 9-1 punitive compensatory ratio—even those that exceed it to a significant degree—may still comply with due process. The Court apparently has no problem with awards that exceed 9-1 to a small degree or even a moderate degree. So, just what is a “significant degree”? Certainly exceeding the maximum single-digit ratio (9-1) by up to 145-1 (as in *Campbell*) is doing so to a significant degree. But is exceeding a 9-1 ratio to 18-1 or 27-1, for example, done to a significant degree – that is, multiplying the maximum single-digit ratio by just 2 or 3, rather than over 16 (as in *Campbell*)?

That the *Diamond Woodworks* case capped the ratio at 4-1 demonstrates that it has inverted the Supreme Court's language by equating “single-digit” and “one.” For it appears that this appellate court arrived at 4-1 by concluding that this ratio did not exceed 1-1 “to a significant degree.” Yet the term “single digit” appears to be more fairly and accurately read as anywhere from 1-1 to 9-1.

Similarly, the above second quote from *Campbell* also should not provide genuine salvation to defendant insurers from large punitive awards. That is, this language used by the Court is not only tentative (“perhaps”), but also explained, contrasted, qualified, and minimized by the confident language in the Court's very next sentence: “The precise award in any case, of course, must be based upon the facts and circumstances of the defendant's conduct and the harm to the plaintiff.” (Emphasis added.) It is interesting that this quote nowhere appears in the *Diamond Woodworks* decision.

The *Campbell* Court sided with the lesser 1-1 ratio because the Campbells had been awarded \$1 million for just a year and a half of emotional distress. The Court held that this award was “complete” and “substantial” compensation – read, “excessive.” The *Campbell* Court also held that the award was duplicative of punitive damages since based on “outrage and humiliation,” which are inherent in both emotional distress and punitive damages.

#### Actual or Potential Damages Figure in Ratio

Most significantly, however, the *Campbell* Court reaffirmed the prior holding in *BMW* that not just actual damages, but also “potential” damages are to be considered when applying a multiple or ratio for punitive damages. That is, the *Campbell* Court held that the proper ratio or disparity to consider is between “the actual or potential harm suffered by the plaintiff and the punitive damages award.” (Id. at 1520; emphasis added.) The Court later referred to the ratio as “between harm, or potential harm, to the plaintiff and the punitive

damages award.” (Id. at 1524; emphasis added.) Then, the Campbell Court saw fit to quote from a section in BMW that was citing to TXO about comparing “actual and potential damages to the punitive award,” with the Campbell Court’s repeating the italic emphasis that the BMW Court had already given to those words “and potential.”(Ibid.)

Even more significant is the fact that in TXO, the Court acknowledged that it is not merely the potential harm to the individual plaintiff that is relevant to this determination, but the potential harm to other victims of the same practice that is relevant to determining the reprehensibility of the defendant’s conduct and the appropriate ratio:

Taking account of the potential harm that might result from the defendant’s conduct in calculating punitive damages was consistent with the views we expressed in Haslip, supra. In that case we endorsed the standards that the Alabama Supreme Court had previously announced, one of which was “whether there is a reasonable relationship between the punitive damages award and the harm likely to result from the defendant’s conduct as well as the harm that has actually occurred.”(TXO,supra,at460; initial emphasis added by TXO Court, latter emphasis added.)

To demonstrate the rationale and importance of considering potential damages in a punitive award, the TXO Court noted the analogous case of a man wildly firing a gun into a crowd, luckily injuring no one, and causing the only damage to a \$10 pair of glasses. If there is only \$10 in compensatory damages, then thousands of dollars in punitive damages would still be allowable in order “to teach a duty of care” and “to discourage future bad acts” – because of the potential harm that might result from the defendant’s conduct.

As the TXO Court put it, “It is appropriate to consider the magnitude of the potential harm that the defendant’s conduct would have caused to its intended victim if the wrongful plan had succeeded, as well as the possible harm to other victims that might have resulted if similar future behavior were not deterred.” (Emphasis in original.)

And so, there must be a reasonable relationship between the punitive award and “the harm likely to result from the defendant’s conduct as well as the harm that actually has occurred.” (Ibid., quoting Pacific Mutual Life Ins. Co. v. Haslip (1991) 499 U.S. 1, at 21; emphasis added.)

Thus, Justice Ginsburg in her Campbell dissent noted that the Court in TXO affirmed a state-court award 526 times greater than the actual damages awarded by the jury in that case, but that if the focus switched from actual damages to potential loss to the plaintiffs had the defendant succeeded in its fraudulent scheme, the relevant ratio in TXO was just 10 to 1.

The key, then, is to maximize the actual or potential damages base before any ratio – whether it be 4-1, 9-1, or even a ratio to a significant degree higher – is applied to calculate the appropriate punitive award.

### Campbell’s Roadmap for Discovery and Trial

The law established in TXO, BMW, and Campbell provides a road map to plaintiff attorneys pursuing large punitive awards for conducting discovery, deciding what evidence to obtain, and planning what trial strategy to undertake. More specifically, Justice Kennedy, who wrote the majority Campbell opinion, noted in his TXO concurrence that a jury must consider only the evidence presented to it in arriving at a judgment; and in TXO there was no evidence, argument, or instructions regarding the potential harm from TXO’s conduct and so would not have allowed a reasonable jury to render its verdict on that basis.

In her dissent in TXO, Justice O’Connor argued that the “potential harm” theory in that case was “little more than an after-the-fact rationalization invented by counsel to defend the startling award on appeal.”(TXO, supra, 113S.Ct.at484-485.) Justice O’Connor explained that the record nowhere contained estimates of the potential loss, which was claimed only after the case was on appeal.

Justice O’Connor’s TXO dissent then indirectly coaches plaintiffs’ counsel on how to support a large potential-based punitive award. Expert and lay witnesses must testify to the potential-loss figure. The jury’s attention should be directed to the technical documents calculating the potential-damages figures. And trial counsel should tell the jury how to pull all these numbers together to calculate the potential-loss figure.

More particularly, plaintiffs should retain forensic economists to explore all potential damages, particularly to

California victims and to the State in general. Both discovery and investigation should be geared from the start to obtaining all the foundational data of the defendant insurer's potentially fraudulent or otherwise bad-faith scheme affecting many of its insureds.

This type of discovery can and should be predicated on the guidelines set out in *Colonial Life & Acc. Ins. Co. v. Sup. Ct. (Perry)* (1982) 31 Cal.3d 785, 790-792, which permits plaintiffs to inquire into other claims and claim files handled by the same insurance representative regarding other insureds to determine whether there is a pattern of unfair claims handling or that the insurer was aware of the representative's misconduct.

As the *Campbell* case held, and as even the *Diamond Woodworks* holding affirmed, defendant insurers may be punished for conduct similar or bearing a relationship to that which injured the particular plaintiff in each case. The key, then, for plaintiffs is to introduce at trial sufficient evidence of repeated misconduct of the sort that injured them. This necessitates the above *Colonial Life* discovery.

As a result, plaintiffs' trial strategy should focus on not just the harm caused to these particular plaintiffs, but also the harm caused to similarly situated insureds caused by the same insurer, which would also figure into the potential damages.

## Conclusion

In the end, the punitive damages imposed are equal to a judicially approved multiple of the actual or potential damages that you prove. So regardless of the multiplier used, the key for the plaintiffs' counsel is to focus on proving the actual and potential damages that have resulted from the insurer's conduct.

Even with a ratio of just 9-to-1, 4-to-1, or even less, punitive damages based on potential harm can still be significant and substantial enough to serve their purpose of punishing defendant insurers and deterring any future malice, oppression, and fraud that victimizes their insureds.