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STATEMENT OF THE ALLIANCE FOR FAIR LEGAL REFORM IN SUPPORT OF S. 1554 THE FAIRNESS IN PUNITIVE DAMAGE AWARDS ACT SUBMITTED TO THE SENATE JUDICIARY COMMITTEE UNITED STATES SENATE

AUGUST 26, 1998

ALLIANCE FOR FAIR LEGAL REFORM

American Automobile Manufacturers Association
American Council of Life Insurance
American Tort Reform Association
Civil Justice Reform Group
Mortgage Bankers Association of America
National Association of Realtors
National Federation of Independent Business
U.S. Chamber of Commerce

AND

Association for California Tort Reform
Association of California Life & Health Insurance Companies
California Society of Certified Public Accountants
Central California Citizens Against Lawsuit Abuse

The Alliance for Fair Legal Reform represents businesses from across the country, active in various -- and sometimes, competing -- sectors of the economy. Yet, we all agree that abusive punitive damage awards in financial injury cases are a very serious problem that must be addressed by Congress. We believe strongly in the civil justice jury system, and we are not seeking the elimination of punitive damages. Instead, we support S. 1554, the Fairness in Punitive Damage Awards Act, introduced by Senators Hatch and Lieberman, because we believe it would strengthen the system by making punitive damages in financial injury and minor physical injury cases proportionate to the harm. Such action would be consistent with the beliefs of the American public, which strongly supports the passage of federal legislation in this area.

Excessive Punitive Damages in Financial Injury Cases

While punitive damages have long been a part of the civil justice system, large and frequent punitive damage awards, especially in financial injury cases, are a recent phenomenon. In California, for example, the largest reported punitive damage award affirmed on appeal between 1872 and 1959 was $10,000. In sharp contrast, the single largest award affirmed on appeal in California in the 1980s was $15,000,000 -- 1,500 times the amount of the largest award during the State's first 187 years of existence.

Cases with excessive awards and extraordinary ratios of punitive damages to compensatory damages abound:

* In 1995, a Mississippi jury awarded a car loan customer of a bank $500,000 in compensatory damages and $38 million in punitive damages after finding that the bank wrongfully charged $9,000 in insurance costs to the customer.

* In 1995, an Alabama jury awarded $25 million in punitive damages to a man who alleged that he was defrauded on a $25,000 life insurance policy. The jury found that an insurance agent had represented that the man would receive the $25,000 life insurance policy in return for a one time only payment of just under $5,000. Six years later the man received a second premium notice for $843.

It was awards such as these that led the prestigious American College of Trial Lawyers to conclude as early as 1986 that awards often bear no relation to deterrence and merely reflect a jury's dissatisfaction with a defendant and a desire to punish, often without regard to the true harm threatened by a defendant's conduct.

The dramatic increases in punitive damage awards have been well documented. A comprehensive study by the Washington Legal Foundation compared punitive damages awarded to individuals in suits against businesses in New York, Texas, California, Illinois and Florida for two periods, 1968-71 and 1988-91. These states represent 36 percent of the United States population. The study found that in 1968-71, there were 91 such punitive damage verdicts totaling $6,994,000. Twenty years later, in 1988-91, there were 433 punitive damage cases with verdicts totaling $790,247,000.

The changing role of punitive damages in financial injury cases first became apparent in a study published by the U.S. Department of Justice in July 1995. The study, drawn from data on 12,000 civil jury trial cases decided in state courts in the nation's 75 most populous counties for a one year period ending June 30, 1992, found that 46 percent of all punitive damage awards were in "contract" cases, cases that involved no physical injury. These cases accounted for 63 percent of all punitive damage awards.

The RAND Institute for Civil Justice followed up with a comprehensive study of punitive damages in financial injury cases that was published in June 1997. The study looked at all jury verdicts during 1985-94 from all jurisdictions in California and New York, as well as from St. Louis, Cook County (Chicago) and Harris County (Houston). Separately it analyzed jury verdicts from all of Alabama from 1992 to 1997.

The study revealed that punitive damages in financial injury cases doubled in less than 10 years, from $1.2 billion in 1985-89 to $2.3 billion in 1990-94.[7] Other key findings documented the fact that abusive punitive damage awards in financial injury cases are a pervasive problem:

•Financial injury cases constitute by far the largest category of punitive damage awards. About 47 percent of all punitive damage awards occurred in cases involving financial injuries only, and no injuries to either persons or property.

•Punitive damages are awarded in one-seventh of all financial injury verdicts. California juries awarded punitive damages 21 percent of the time.9 Punitive damages are most frequently awarded in disputes arising out of insurance, employment and real estate transactions, or other contractual relationships.

•During the period studied, the average award in the five jurisdictions rose from $3.4 million to $7.6 million.11 Real estate firms, insurance companies, banks, credit businesses and securities dealers are all at risk, facing average industry awards ranging from $2.1 million to $30 million.

•Punitive damages at the 90th percentile level (where only 10 percent of the awards are higher) rose even more, trebling from $3.9 million to $12 million.13 These awards are the most important for businesses because, as the RAND report states, "in assessing risks, most business decision makers focus on worst-case scenarios . . . ."

•Punitive damages awarded in many cases bore no rational relationship to the financial injury suffered -- 34 percent of the cases, with 40 percent of the dollars awarded, exceeded a ratio of three times the amount of economic plus noneconomic damages.

•In the period from 1990-94, punitive damages in financial injury cases (including cases in which there was no punitive award) constituted 59 percent of all damages awarded.

•In Alabama, which RAND examined separately, punitive damages constituted over 80 percent of all damages awarded in financial injury cases.

These figures, as dramatic as they are, do not begin to tell the whole story. The RAND study alludes to the "shadow effect" of punitive damages,18 the impact that jury verdicts have on business decisions, including the decision to settle cases. Punitive damage jury verdicts are extremely important because they "cast a shadow" on the vast majority of cases that are settled.

At the July 29 Senate Judiciary Committee hearing, Mark Dapier, General Counsel of Mercury Finance Company, demonstrated the shadow effect of a bad punitive damage decision. In 1994, Mercury was hit with a $50 million punitive damage judgment in Alabama in a case in which it purchased a car buyer's note from an auto dealer at a discount of $1,000 off the face value. Despite the fact the buyer got the car for the price it negotiated with the dealer and Mercury Finance fully complied with Federal Truth in Lending and state disclosure laws, the jury made the punitive damage award under an Alabama law that prohibits "fraudulent suppression," the failure to disclose a material fact to the consumer. Ultimately, Mercury Finance received a remittitur to $2 million and settled the case for slightly less.

The shadow effect of the case was significant. Unwilling to risk another huge verdict in a series of copycat cases filed by the same attorney in the same court, Mercury Finance settled nine other cases with the attorney for an amount in excess of $4 million. Thereafter, the number of lawsuits filed against Mercury in the State of Alabama rose from three in 1992 to a total of 105 between 1994 and 1996. Eventually, Mercury won the discount disclosure issue in federal court in Alabama, putting an end to cases in that State. However, the problem spread to other states. In Georgia, 12 suits were filed immediately after the original Alabama verdict charging

the company with the same conduct. Mercury eventually won those cases with a decision finding that the practice of purchasing retail installment contracts at a discount was perfectly legal. However, this verdict did not occur until four years after the Alabama case. Mercury's practices were also challenged in Illinois. Two Illinois courts subsequently ruled that Mercury's conduct was legal and appropriate.

The price for one rogue verdict granting punitive damages for a legal, everyday business practice -- just in terms of settlement costs and Mercury's own attorneys' fees -- was nearly $11 million. The costs were borne initially by a corporation that engaged in legitimate business conduct, and ultimately by the customers of that business in all 27 states in which it operates.

Excessive Punitive Damages Are a Nationwide Problem That Requires a National Solution

State punitive damage laws vary widely. Five states -- Louisiana, Massachusetts, Nebraska, New Hampshire and Washington -- prohibit the imposition of punitive damages. Another 14 states limit punitive damages in some or all situations, most frequently by establishing some limit on the ratio of punitive damages to other damages. The rest of the states set no limits on punitive damages.

Regardless of what a particular state's law is, it is impossible to hide from excessive punitive damages. A corporation headquartered in Massachusetts, a state that prohibits punitive damages, is directly affected by an excessive punitive damage award in Texas. A high enough award may jeopardize the future of that corporation, its employees and its suppliers. Not only are Massachusetts corporations adversely affected by out-of-state punitive damage awards, so are its citizens. Insurers and banks, among many others, operate on a nationwide basis. An outrageous punitive damage award in Mississippi against a California business will raise the cost of products and services in Massachusetts as surely as it will raise them in Mississippi. That is the nature of our society today.

Professor George Priest of Yale Law School, in his July 29 statement before this Committee, identified another problem with interstate implications. He testified that the average punitive damage verdict affirmed by the Alabama Supreme Court over the period 1989-96 against an out-of-state defendant was 8.75 times higher than against an Alabama defendant. Juries, unfortunately, are all too often willing to provide this kind of "jackpot justice," sending a lesson to outsiders.

The Texas Public Policy Foundation has also done work on the broader societal impact of punitive damages. It is clear that punitive damages have a far greater impact than merely allocating resources between plaintiffs and defendants. As the Texas study found, the cost of punitive damage awards "may be shifted to employees, vendors, customers and others in the form of lower wages, lower demand, higher prices, and so forth, respectively."

The Texas Public Policy Foundation study reached the broader conclusion that businesses are diverting more and more resources away from innovation into defensive measures to protect themselves against the risk of huge punitive damage verdicts:

Reacting to a significant increase in the incidence and variability of punitive damages, businesses have apparently shifted greater and greater resources into risk management and insurance or self-insurance to protect against potential financial ruin. This expense means less

capital is being placed in new product designs and other innovations. Expenses are then shifted forward through price adjustments to customers and backward by means of changes in payment levels to employees and management, bondholders and other creditors and vendors. The burden is also shifted through the insurance mechanism to other policyholders.

The reality is that when punitive damages are excessive, out of all proportion to the harm done, they no longer merely punish the wrongdoer -- they can wrongfully devastate the defendant business, its employees and suppliers and everyone associated with that business, including its customers. The ripple effects are not limited to that state in which the judgment is made. In a national economy, where prices are typically set nationwide, excessive punitive damages punish consumers everywhere.

The states cannot solve this problem. Massachusetts can protect neither its corporations nor its citizens from the impact of an unfair decision in California or any other state. In fact, the states have little incentive to act. Restrictions on punitive damages in their states will not protect their national corporations from excessive out-of-state awards. The only effect of a state adopting restrictions on punitive damages will be to reduce the possibility that the citizens of that state will enjoy a windfall punitive damage award. Such a result does not invite state action.

A disturbing new trend has emerged. States that have chosen to act have increasingly found themselves rebuffed by their own state courts, on state constitutional grounds that do not arise under the federal Constitution. In recent years, the highest courts in Alabama (in 1993) and Illinois (in 1997) have struck down civil justice reform statutes that included punitive damage limitations. A punitive damage limitation in Ohio is presently being challenged before the Ohio Supreme Court.

The BMW Case Identifies the Problem But Doesn't Provide the Solution

On May 20, 1996, the Supreme Court in BMW of North America v. Gore, 116 S. Ct. 1589 (1996), ruled that a $2 million punitive damage award for a $4,000 loss in the value of a car that had been repainted before delivery without Dr. Gore's knowledge was "grossly excessive" and violated the Due Process Clause of the 14th Amendment. It was the first time that the Supreme Court had found a punitive damage award so high as to violate the Constitution.

The Supreme Court identified the problem and has invited Congress to solve it. While the Court found a punitive damages to compensatory damages ratio of 500 to 1 to violate the 14th Amendment, it did so only in the context of the case. Specifically, the Court established a broad three-pronged test to assess constitutionality. The three elements are the degree of reprehensibility of the defendant's conduct, the ratio of punitive damages to the actual harm inflicted on the defendant, and State criminal and civil sanctions for similar conduct. Interestingly, both the concurring opinion of Justice Breyer and the dissenting opinion of Justice Ginsburg cite State laws that establish ratios between punitive damages and other damages as appropriate exercises of legislative power in this area.

Because BMW did not establish a bright line test of constitutionality, excessive punitive damage awards continue to plague the system. This Committee heard about one such case during its July 29 hearing, Auerbach v. Great Western Bank, Los Angeles Superior Court Case No. SC 034865 (1997). In that case, sophisticated real estate developers with a net worth of $70 million purchased a commercial building from Great Western Bank and borrowed $2 million

from the bank to facilitate the purchase. Five years later, when the favorable lease the Auerbachs had with their sole tenant ended and a decline in the local real estate market prevented them from negotiating a similar lease, the Auerbachs sought to renegotiate its loan with the bank. When the parties were unable to work out a mutually acceptable agreement, the Auerbachs sued, basing their claim on the allegation that the bank's loan workout representative failed to disclose his personal philosophy not to agree to any loan modifications if the loan payments were current. The plaintiffs said if they had known about the loan officer's view, they would have stopped making payments on the note, even though they were legally obligated to continue them.

Based on these allegations, the jury awarded the plaintiffs $207,155 in compensatory damages for having made their loan payments during loan renegotiation discussions and $2.6 million in punitive damages, a ratio of 12.6 to 1. As with the situation in the BMW case, this was a matter involving only economic damages. Moreover, in this case, the plaintiffs had a legal obligation to pay off the loan and the defendant was entitled to such payments. Furthermore, there was no evidence that any other customer of the bank had ever been damaged by similar conduct by a bank officer. Yet the jury, virtually all of whom had professional careers, still found a basis to not only rule for the plaintiffs but to assess an outrageous amount for punitive damages. How was the punitive award determined? The answer lies in the fact that during the punitive damages phase of the trial, the plaintiffs' counsel placed a large poster board blow-up in front of the jury which reflected the bank's net worth of $2.6 billion. The attorney encouraged the jury to make an award based on a percentage of the defendant's net worth and that is what they did.

It is worth noting, as did Tim Lambirth, the bank's counsel, that "Organized crime would have been treated better than GWB (Great Western Bank)." As he explained at the hearing, "Had organized crime been engaged in fraud resulting in financial injury and someone brought suit against them, claiming a RICO (Racketeer Influenced Corrupt Organizations Act) violation, all organized crime would have been responsible for would be treble damages," or $600,000.

How Unconstrained Punitive Damages Can Cause Massive Harm to the U.S. Economy: The Year 2000 Problem

At the July 29th hearing, Jeff Jinnett, President, LeBoeuf Computing Techologies, LLC, testified that the Year 2000 problem could result in massive litigation that would dwarf existing litigation problems. In his testimony, Mr. Jinnett cited the estimate of one of many experts in this field who believe that so-called Y2K-related litigation might near or exceed $1 trillion, or more than 3 times the estimated $300 billion total annual direct and indirect costs of all civil litigation in the United States.

While litigation costs are speculative, it is important to note that several class action lawsuits have already been filed against software vendors for selling software which is alleged to have been defective because it was not Y2K compliant and for charging their customers for upgrades to make them work in the Year 2000 rather than issuing the upgrades for free. Moreover, as Mr. Jinnett pointed out in his testimony, "Punitive damages also have been awarded in the past in connection with computer-related systems failures involving claims of fraud or intentional misrepresentation." There are many other causes of action for purely financial harm that will inevitably arise out of Y2K failures. Analogous claims in other areas have resulted in punitive damage awards.

While some Y2K problems may result in serious physical harm, a significant portion of the damages will be purely financial in nature, the kind which would be covered by S. 1554. If these punitive damage claims are not constrained in Y2K cases, they could contribute to a litigation explosion whose costs could dwarf the remediation costs and exacerbate Year 2000 economic troubles in the United States and elsewhere.

S. 1554 Provides a Solution that Balances All Interests Fairly

Inasmuch as the BMW decision establishes the principle that punitive damages may be so grossly excessive as to violate the 14th Amendment of the Constitution, then S. 1554 establishes a fair set of ground rules for balancing the interests involved in punitive damage awards -- those of the plaintiff, the defendant and the public. These rules carry out the constitutional admonition articulated in the BMW case that, "Elementary notions of fairness enshrined in our constitutional jurisprudence dictate that a person receive fair notice not only of the conduct that will subject him to punishment but also of the severity of the penalty that a State may impose."[emphasis added]

When the decision of a jury in any jurisdiction in this country can alter the business practices of a corporation throughout the nation and the cost of its products and services to consumers everywhere, then it is incumbent upon the Congress to legislate to protect the national interest. As the Court said in the BMW decision, BMW's "status as an active participant in the national economy implicates the federal interest in preventing individual states from imposing undue burdens on interstate commerce."

S. 1554 sets forth the rational principle that punitive damages, which are designed for both punishment and deterrent purposes, should be proportional to the harm inflicted. In short, just as in criminal law, the punishment should fit the crime. In this regard, as Professor Priest stated in his testimony before this Committee at the July 29 hearing, S. 1554 would finally start the same process of having the legislature set a statutory maximum penalty for the area of civil law -- punitive damages -- that is most analogous to criminal law. The bill would end the present authority of a jury to put a defendant out of business -- to impose a commercial death penalty -- for conduct that might be more akin to assault than murder.

The bill's proportionality approach finds strong support in the literature on punitive damages. In 1989, the American College of Trial Lawyers, a prestigious body of both plaintiff and defense attorneys, expressed concern that, with no statutory limits on punitive damages, "The opportunity for bias and prejudice to operate is too great." The report echoed the concerns of Professor Priest, saying that "It would be unthinkable to use such vague standards to assess punishment in the criminal system, much less to let a jury do it."

To avoid these problems, the College recommended that "the various legislative bodies enact a statute which limits the recovery of any punitive award by a plaintiff in a tort case to twice the amount of the compensatory award or $250,000, whichever is greater." The College concluded that "this approach is fair to all concerned in that the award would punish and deter and yet not unjustly subject defendants to ruinous liability."

Two years later, in 1991, Harvard Law School Professor Paul Weiler, the Reporter for the American Law Institute in this area, identified the problems in the tort system as being focused more on excessive awards than on appropriate standards. He stated, "We observed earlier that greater responsibility for the recent dislocation experienced in tort litigation and insurance markets is attributable to the principles governing damage awards than to those

specifying initial liability. Consequently, we recommend more extensive changes in this branch of tort law."

Professor Weiler suggested two possible ways to address this problem with respect to punitive damages. One of his suggestions mirrored the approach recommended by the American College of Trial Lawyers. Professor Weiler suggested that, "a ratio should be established between the amount of the compensatory damages awarded to the plaintiff and the amount of punitive damages permitted in the suit, with an alternative monetary ceiling that would authorize the higher award in cases in which especially egregious wrongdoing happens to inflict only modest harm on a particular plaintiff."

S. 1554 adopts a similar approach to proportionality in punitive damage cases that involve primarily financial injury. For large businesses, the bill's formula would authorize a maximum award of the greater of 3 times economic damages or $250,000. The authors of the legislation are wise to use economic damages rather than compensatory damages for this category of cases in order to eliminate any incentive for plaintiffs' attorneys to seek high awards for noneconomic damages in order to generate higher punitive damage awards. Since most of the cases covered by the bill are financial injury cases, there are rarely awards for noneconomic damages, nor should there be. The legislation is wisely crafted to prevent any abuse of another area of law.

With respect to small business, S. 1554 sets a ceiling of the lesser of 3 times economic damages or $250,000. A similar formula was adopted by the Senate on a voice vote in 1995 and recently President Clinton expressed approval of that formula in the context of product liability claims against small business. The threat of an excessive punitive damage award chills far too much productive activity by small business, both old and new alike.

S. 1554 differs from punitive damages legislation considered in the last Congress. It does not apply to all civil actions. While the 104th Congress supported such legal reform, the debate over H.R. 956, the Common Sense Product Liability Legal Reform Act of 1996, made it clear that the Administration as well as some members of the House and Senate objected to limiting punitive damages in cases that result in serious physical injury, such as death, loss of fertility, burns and other lifelong disabilities. S. 1554 addresses these concerns by limiting its applicability to cases that do not result in "death, serious and permanent physical scarring or disfigurement, loss of a limb or organ, or serious and permanent physical impairment of an important bodily function."

In 1995, President Clinton raised two other objections to punitive damages legislation. He objected to applying limits on punitive damages to certain categories of behavior such as drunk driving, crimes of violence, terrorism, perpetration of hate crimes and felony sexual offenses. This bill specifically carves out these offenses from the application of the law. It also would not change any federal law with respect to punitive damages, such as the federal anti-discrimination laws. In his veto message on H.R. 956, the President also expressed concern that "arbitrary ceilings on punitive damages endanger the safety of the public. The provisions of S. 1554 are not arbitrary and they are not directed at the kinds of cases which represent a safety risk to the public.

S. 1554 does not apply to these areas in which there is no consensus. Instead, its main application would be to financial injury cases, which the RAND study documented was the bulk of the punitive damages problem. These cases involve disputes over money and, as such, are

ones in which injured persons may be put back in the position they were in prior to the wrongful act through the payment of money.

The bill would also cover cases of minor physical injury, those that do not fit into the exempted categories of death and very serious injuries discussed above. While cases of minor physical injury are rarely the subject of punitive damages, the bill wisely carves them out to prevent the plaintiff's bar from doing an end run around the statute. If the bill applied only to cases that did not involve any physical injury, it would be too easy for a clever attorney to circumvent the bill's intent. Imagine, for example, what could take place when a person who had been defrauded out of $1,000 called a lawyer to ask him to take the case. An unscrupulous lawyer might well respond, "Make two calls to a doctor and call me in the morning." One prescription for an upset stomach or headache would defeat the whole purpose of the law.

Some opponents have raised the question of a conscious scheme by a company to defraud its customers on the premise that it would make more money that way even if it had to pay off on the few claims that people were willing to pursue. This hypothetical is a good way to test the fairness of this bill.

The answer is that the bill would punish such behavior harshly because it establishes a limit for each plaintiff. The result would be that any company that defrauded large numbers of people would be subjected to severe penalties, even if the individual amounts involved were small. For example, the maximum punitive damage award against a company that defrauded 1,000 people out of $1,000 apiece could be $250 million (the alternative cap of $250,000, times each of the 1,000 people cheated). That would be more than enough to deter such a scheme.

Finally, we commend the authors of S. 1554 for establishing a minimum federal standard for punitive damages rather than a federal rule. Five states have already chosen to abolish punitive damages entirely, while several others restrict punitive damages more tightly than this bill would. Congress has often taken the approach of minimum federal standards, setting the policy direction for states, but permitting the states to go further in that direction if they wish. Such is true of many of the consumer banking laws, as well as the Clean Air Act and the Clean Water Act. Such an approach particularly makes sense in an area where the subject matter, punitive damages, is just one of many factors to punish and deter misconduct. Other penalties include the criminal law, awards for economic and noneconomic damages (which would not be limited by this law), state and federal regulatory agencies and loss of business from the loss of a business' good reputation. These other penalties strongly reinforce the objectives of punishment and deterrence while making sure the penalties are proportionate to the harm committed.

Mr. Chairman, the Alliance for Fair Legal Reform commends you for devising a balanced solution to the real world problem of "jackpot justice." It is time to put an end to exorbitant punitive damages which hurt society as a whole by discouraging innovation, reducing employment, raising consumer prices and lowering shareholder prices. S. 1554 fairly balances the interests of plaintiffs, defendants and society as a whole. Its enactment will make sure that society's interests are properly protected while wrongdoers are punished fairly for the harm they cause.